From Nudges to Mandates: Dodd-Frank Mortgage Regulation as Case Study

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Passed in the aftermath of the Great Recession, the Dodd Frank Wall Street Reform and Consumer Protection Act of 2010 exemplifies what the late Larry Ribstein called a "bubble law": [1] panic legislation passed in the immediate aftermath of a financial crisis, more likely to chill beneficial market innovation than to deter actual market misbehavior. Just as Sarbanes Oxley was enacted as a response to the Enron scandal, so too was Dodd Frank enacted as a response to the financial crisis of 2007 and the Great Recession which began in 2008 (and continues until today). Like Sarbanes Oxley and the Enron scandal, Dodd Frank was based on a set of beliefs about the causes and consequences of the housing boom and collapse that occurred in (most of) the United States over the period 2002-2008. These beliefs are directly reflected in the text of the Dodd Frank Act. In the area of residential mortgage contracts, the area that is my particular focus here, Dodd Frank prohibits a wide range of contract terms, imposes a new obligation on lenders to ensure that mortgage terms are "suitable" for particular borrowers, and imposes clear risks on any lender that dares to write mortgage contracts that differ substantially from statutory "qualified" mortgages.

Depending upon the way they are implemented in regulations promulgated by the new Consumer Financial Protection Bureau, these provisions of Dodd Frank may well transform consumer mortgage lending. However, when one takes a close look at the actual evidence, the assumptions about the role played by different types of mortgage contracts in the housing boom and collapse that underlie Dodd Frank turn out to be problematic at best. Similarly, when one looks at the approach taken by Dodd Frank to fix those problems – as by requiring that lenders ensure borrowers have a "reasonable ability to repay" their mortgage loans – it seems clear that the approach will not work at all as it does in other areas. Dodd Frank's "reasonable ability to repay" standard is supposedly modeled after the "suitability" obligation imposed on brokers and dealers under the securities laws. Not only may the securities law suitability standard be soon replaced by an enhanced fiduciary standard, but Dodd Frank's application of any such standard to mortgage lending is likely to result not in relatively clear rules about a few products or transactions that mortgage lenders must avoid (as it has for brokers), but a drastically restricted set of mortgage contracts. Dodd Frank was inspired by behavioral economic work suggesting that regulators should steer consumers toward better contractual choices rather than mandating such choices. In the actual Dodd Frank world, however, where lenders face potentially massive ex post liability for allowing consumers to choose "predatory" mortgages, nudges have already begun to collapse into mandates. This restriction of the set of contracts from which consumers may choose is likely to harm the very subset of consumers that it is intended to help and will inevitably entail

[1] **See** Larry E. Ribstein, Bubble Laws, 40 Houston L. Rev. 78, 97 (2003). See also Henry N. Butler and Larry E. Ribstein, The Sarbanes Oxley Debacle: What We've Learned; How to Fix It (2006).

huge consumer welfare losses. Ironically, these losses will be inflicted even as new evidence suggests that much consumer confusion about mortgage contract terms could be eliminated if regulators crafted better disclosures on the basis of very well understood principles known to both regulators and marketing researchers. Rather than improving regulatory incentives for such relatively easy improvements, however, Dodd Frank points blame at consumers and businesses, choosing a course that is politically most valuable but socially most damaging.

I. Dodd-Frank and the End of the Arms Length Consumer Borrower – Residential Mortgage Lender Relationship

Title X of Dodd Frank created the new Consumer Financial Protection Bureau (CFPB). According to the statute, the CFPB is to "implement and, where applicable, enforce Federal consumer financial law consistently for the purpose of ensuring that all consumers have access to markets for consumer financial products and services that are fair, transparent and competitive."[2] The CFPB has the authority under Dodd-Frank to promulgate regulations to prevent covered institutions from committing "unfair, deceptive or abusive" acts and practices in connection with consumer financial products or services.[3] The terms "unfair" and "deceptive" appear in Section 5 of the FTC Act[4] and have been defined and refined by FTC decisions and regulations. Dodd Frank tracks the existing FTC approach to defining "unfair" practices by directing that the CFPB classify a practice as "unfair" only if it has a reasonable basis to conclude that the practice causes "substantial injury" to consumers and is not outweighed by "countervailing benefits to competition" or is "reasonable avoidable."[5]

The term "abusive," however, is new, created by Dodd-Frank. Dodd Frank directs that the CFPB is to find a practice "abusive" if it "materially interferes with the ability of a consumer to understand a term or condition" or takes "unreasonable advantage" or a consumer's lack of understanding, inability to protect self-interest, or reasonable reliance.[6] Dodd Frank bans some practices, suggesting that they (and perhaps others) are per se "abusive." The law prohibits the payment of compensation to loan originators that is based on the interest rate or other loan terms;[7] prepayment penalties on certain types of loans;[8] and, mandatory arbitration provisions in mortgage loan contracts.[9] Finally, and more directly, Dodd-Frank amends the Truth in Lending Act to authorize the Federal Reserve Board to ban "abusive or unfair lending practices that promote disparities among consumers of equal creditworthiness but of different race, ethnicity, gender and age."[10] The prohibition on "abusive" lending practices is to be enforced both

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[2] Section 1021(a), Dodd-Frank Act, 12 U.S.C. 5511(a).
[3] Section 1031(a) of Dodd-Frank, 12 U.S.C. 5531(a).
[4] 15 U.S.C. Sec. 45.
[5] Section 1031 (c) of Dodd Frank, 12 U.S.C. 5531.
[6] Section 1031(d) of Dodd Frank, 12 U.S.C. 5531
[7] Section 1403, Dodd-Frank Act.
[8] Section 1414, Dodd-Frank Act.
[9] Sections 1028 and 1414, Dodd-Frank Act, which also requires the CFPB to conduct further study to determine whether to extend the ban on mandatory arbitration to all consumer products.
[10] Section 1403, Dodd-Frank Act.

through ex ante CFPB regulation and ex post litigation brought by the CFPB or state attorney generals, who are expressly given enforcement authority under Dodd Frank.

Dodd-Frank transforms the relationship between consumer borrowers and residential mortgage lenders by requiring that a mortgage lender "make a reasonable and good faith determination based on verified and documented information….that the consumer has a reasonable ability to repay the loan."[11] Dodd Frank creates a presumption that this "ability to repay" standard is met by "qualified mortgage loans," which are those that are for less than or equal to 30 years, are fully documented in terms of borrower income and debt, fully (including taxes and insurance) self-amortizing, that have no balloon payments and whose fees and points are less than three per cent of the loan amount, and which, finally, are in compliance with any regulations that the CFPB shall promulgate regarding ability to repay.[12] The statute contains related and somewhat more general guidance for the CFPB in developing such regulations, specifying factors – such as the borrower's debt to income ratio and total financial resources – that such regulations might include.[13]

Having authorized the regulatory prohibition of "abusive" mortgage loans and set up a safe harbor for "qualified" mortgage loans, Dodd Frank also requires the CFPB to promulgate regulations prohibiting "steering" of customers to disfavored or illegal loans. Section 1403 of Dodd Frank directs the CFPB to promulgate regulations to prohibit lenders from "steering a consumer to a mortgage loan that the consumer lacks the reasonable ability to repay or which has predatory characteristics (such as equity stripping, excessive fees, or abusive terms." That same section requires regulations prohibiting lenders from "steering" a consumer from " a residential mortgage loan for which the consumer is qualified that is a qualified mortgage to a residential mortgage loan that is not a qualified mortgage." Hence "qualified" loans under Dodd Frank are more than a safe harbor; if they are offered, then a consumer cannot be allowed to choose a different and arguably riskier mortgage.

Prior to Dodd-Frank, courts viewed the relationship between a consumer borrower and a residential mortgage lender as an arms-length transaction in which each side was free to advance its own interests, subject of course to common law contract defenses such as fraud.[14] Judges had refused to impose a duty on lenders to refrain from making a big mortgage loan to a consumer even when the lender should have known that the consumer could not repay the loan, and likewise lenders had no duty to ensure the accuracy of home value appraisals, or to make or pay for a property inspection, and no

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[11] Section 1411(b) , Dodd-Frank Act, amending 15 U.S.C. Sec. 1631.

[12] Section 1412 of Dodd Frank. ''…(vi) that complies with any guidelines or regulations established by the Board relating to ratios of total monthly debt to monthly income or alternative measures of ability to pay regular expenses after payment of total monthly debt, taking into account the income levels of the borrower and such other factors as the Board may determine relevant and consistent with the purposes described in paragraph (3)(B)(i)"

[13] Section 1411(b)(3) Dodd-Frank Act says that "reasonable ability to repay factors" may include "…consideration of the consumer's credit history, current income, expected income the consumer is reasonable assured of receiving, current obligations, debt-to-income ratio or the residual income the consumer will have after paying non-mortgage debt and mortgage-related obligations, employment status, and other financial resources other than the consumer's equity in the dwelling…."

[14] See Frank A. Hirsch, Jr., The Evolution of a Suitability Standard in the Mortgage Lending Industry: The Subprime Meltdown Fuels the Fires of Change, 12 N.C. Banking Inst. 21, 22-23 (2008).

general duty of care in making the mortgage.[15] Without facts indicating a special and unusual relationship of trust and confidence between a particular lender and borrower (as where the lender acted as the borrower's financial advisor), lenders had no duty to explain the particular terms of a mortgage loan to a borrower.

The only precedent in federal law for Dodd-Frank's "reasonable ability to repay" requirement was the requirement of the Home Ownership Equity Protection Act (HOEPA) of 1994 that lenders with a "pattern of practice" of asset (versus income) based lending verify ability to repay before making a "high cost" loan.[16] While there had been some regulatory guidance suggesting that the "ability to repay" lender duty be broadened,[17] Dodd-Frank was the first federal law to impose such a general duty on mortgage lenders.

An essentially identical requirement for assuring consumer "ability to repay" is set out in the Credit CARD Act, which regulates issuance of consumer credit cards.[18]

II. Some Justifications for Dodd-Frank

It has been said that Dodd-Frank and the creation of the CFPB marked a "revolution" in consumer protection law.[19] As a purely explanatory matter, the Great Recession of 2008 was at least a contributing factor to and likely a necessary condition for the Dodd-Frank revolution. Congress generally does not act to pass major legislation affecting as many interest groups as did Dodd-Frank without some sort of precipitating crisis. At first glance, however, the connection between the Great Recession and financial meltdown of 2007 and the need for revolutionary change in the federal consumer protection laws is not at all clear. After all, the 2007 financial meltdown involved a collapse of the so-called shadow banking system, a system in which banks acquire funds not via loans from consumers (demand deposits) but with collateralized loans from other banks and financial institutions.[20] What, one might ask, did this have to do things like "abusive" lending to consumers that are targeted by Dodd-Frank?

Now one possible answer is that there was no connection at all, that the Congressional majority and various interest groups seized upon the Great Recession as an excuse to pass big new consumer protection legislation that they had wanted to pass for some time for reasons having nothing to do with the Great Recession. This answer seems wrong. Many advocates of Dodd-Frank and the consumer protection revolution do see a quite direct relationship between the Great Recession and failure of the status quo federal consumer protection regulatory scheme. In brief, the connection is this.[21] Following a

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[15] Hirsch, supra note __ at 23.
[16] John Pottow, Ability to Pay, 8 Berkeley Bus. L. J. 175, 180 (2011).
[17] Pottow, supra note ___ at 182-184.
[18] Credit Card Accountability Responsibility and Disclosure Act of 2009, Pub. L. No. 111-24, Section 109, 124 Stat. 1743 (2009).
[19] Joshua D. Wright, The Antitrust/Consumer Protection Paradox: Two Policies at War with Each Other, 121 Yale L. J. 2216, 2219 (2012).
[20] On the collapse of the shadown banking system, see Gary B. Gorton, Slapped by the Invisible Hand: The Panic of 2007 (2007). For evidence that Gorton (and Andw Metrick) overestimate the role played by repos (repurchase agreements) relative to asset-backed commercial paper in this meltdown, see Arvind Krishmamurth, Stefan Nagel and Dmirty Orlov, Sizing up Repo, Working Paper, Stanford Economics Department, 2011.
[21] This argument is elaborated in fascinating detail by Kathleen C. Engel and Patricia A. McCoy, The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps (2011).

wave of deregulation beginning in the 1980's, by the early 2000's, banks were making all kinds of complicated new mortgage loans to consumers. These loans fueled an unsustainable housing and (through home equity loans) more general economic boom. Many, and by the end of the boom in some markets, even most of these loans had terms that were extremely onerous to average consumers. A typical loan would give the borrower two years of very low interest payments but then require the borrower to begin paying both principal and a much higher (adjusted or reset) interest rate. Borrowers did not typically have the financial resources to make the higher later payments. But originators of the loans didn't care if borrowers defaulted someday because they sold the loans to other firms who used them to collateralize securities that were purchased by various investors. People buying and selling these securities didn't worry about consumers being unable to pay their loans when they reset because they had been assured that the securities they had were so diversified that there was very little risk that a large number of consumers would be in default at the same time. When it turned out that this assumption was wrong – as indeed it had to be, given that the mass marketing of the underlying standardized loan types had itself induced a heretofore non-existent correlation across consumers in different housing markets in their default risk – the loans and the securities they collateralized plummeted in value, locking up the entire financial system that used them as collateral and eventually the economy as well. Mass defaults on the underlying mortgage loans led to mass foreclosures, leaving communities blighted by empty homes and deprived of property tax revenues for basic local public goods such as police and parks.

This entire story rests on ordinary people, "consumers" as Dodd-Frank calls them, agreeing to take out very risky mortgage loans, with terms granting exceptionally low monthly payments in early years in exchange for dramatically higher payments afterward. Similar loans – those with adjustable rates -- had been in existence for some time, but most people had eschewed them in favor of the standard American long-term fixed interest rate right to prepay mortgage. As to why the non-standard, risky mortgages proliferated so rapidly during the 2002-2005 period, there are several possible answers. One is that after being told repeatedly by the Chairman of the Federal Reserve Board Alan Greenspan and other federal officials, including his second-in-command Ben Bernanke, that low interest rates were now a permanent feature of the American economy, and that housing prices would continue to increase for the indefinite future, ordinary people believed that these risky mortgage loans really weren't so risky. If Greenspan and colleagues were right, then the "risky" mortgage loans were actually a pretty safe way to make a lot of money fast. These loans represented one of the few if any ways that an ordinary person could engage in highly leveraged and potentially highly profitable investing: with a very small down payment (very little equity), take out a loan offering low initial terms, and sell the house at (possibly much) higher price, before the loan reset. (And repeat, with a new, larger and higher price house). This of course is speculation. But especially given the public proclamations of Greenspan, Bernanke and other officials during this period regarding the probable continuation of low interest rates and high home prices, it is hardly "irrational" speculation.

I use the phrase "ordinary people" to refer to people of average intelligence and general knowledge, as opposed to sophisticated investors. There is plenty of anecdotal evidence that ordinary people did indeed engage in such speculative investing in homes during the housing boom of 2002-2005, and as discussed below, there is now systematic evidence of such speculative behavior. The intellectual advocates of Dodd-Frank did not need to wait for such evidence before acting. They already knew that ordinary people were not speculating when they took out the risky mortgage loans that fueled the housing boom. Instead, borrowers were being exploited, "steered" into loans that they could not possibly ever repay, but which generated high fees for everybody else – all the way from the people who made or arranged the loans to the investors who bought the securities those loans collaterized. On this view, much of the lending of such high-risk mortgages was "abusive," taking advantage of the various imperfections that characterize the thinking of ordinary people to induce them to agree to mortgages that they could not hope to repay.

Dodd-Frank champions have many examples of what constitutes "abusive" lending in the mortgage market, and the statute directly reflects these examples. For the "abusive" standard to add anything new to consumer protection law, it must cover non-fraudulent" actions that are not either "unfair" or "deceptive," as these terms have been a feature of FTC-enforced consumer law for many years. It turns out that the paradigmatic examples of "abusive" lender behavior adduced by Dodd-Frank advocates involve what is known as "predatory lending."[22] The distinguishing features of "predatory lending" include: 1) high upfront fees and points paid to mortgage originators, often sprung upon borrowers at the last minute, at closing; 2) high and/or escalating interest rates that loan originators knew the borrower could not pay, given his or her income; 3) folding expensive mortgage insurance premiums into the loan (thus increasing the amount of interest owed and closing fees); and, 4) bait and switch tactics where loan originators would describe a loan with favorable borrower terms but fail to lock in those terms and then show up at closing with documents containing much more unfavorable terms, including additional fees for non-existent services. Pre-Dodd Frank Federal law requires massive amounts of disclosure, and in the paradigmatic abusive lending example, the loan originator would comply with all federal disclosure requirements and never actually commit fraud by misrepresenting a fact. Instead, the paradigmatic predatory lender would target vulnerable populations, such as the elderly or poor, minority persons, and "pressure" them to commit to what sounded to be a terrific deal, and then rush through the closing, counting on the borrower's lack of sophistication to ensure that the borrower would not carefully read or understand the various disclosures presented at closing.

Two particularly notorious abusive practices that allegedly became widespread during the housing boom were "steering" and yield-spread-premium (YSP) mortgage originator compensation. To understand both steering and YSP compensation, it is necessary to briefly review how a subprime mortgage differs from the more traditional American mortgage. The traditional American mortgage is for a long term, 15 or 30 years, has a fixed interest rate with monthly interest and principal payments set so that the entire principal is paid off over the life of the loan (the loan is self-amortizing), and has no prepayment penalty. Since the borrower always has the option of defaulting on the loan, this traditional loan gives the borrower both a call option (the right to buy, prepay, the loan at the existing balance) and a put option (the right to default and force the lender

[22] These examples are taken from Engel and McCoy, supra note __ at 21-25.

to take title to the home).[23] Subprime loans are mortgage loans made to borrowers whose credit score is too low for them to qualify for a traditional, fixed rate mortgage. As subprime loans are made to riskier borrowers, they contain terms differing from those found in a traditional mortgage. Characteristically, subprime loans defer the repayment of principal on the loan and sometimes also part of the interest as well. Subprime borrowers thus get to make very low payments for the first years of their mortgage, but after three to ten years, the interest rate "resets" to a level determined by then-prevailing market interest rates, and the borrower also has to begin making principal payments. Indeed, sometimes the borrower has to make a large "balloon" payment equal to past principal repayment which were deferred.[24] Thus the subprime loan ultimately may call for the borrower to pay a much higher and variable interest rate, relative to the traditional fixed rate mortgage. This protects the lender against risk from rising rates. Such loans typically also carry prepayment penalties that effectively increase the cost to the borrower of exercising her call option. This term protects the lender from a fall in interest rates. Finally, as an additional protection against both the risk of default or prepayment by the borrower, up-front points charged at closing.[25]

Steering involved persuading borrowers whose credit score would have qualified them for traditional fixed rate mortgages to instead take costlier and riskier sub-prime loans. Engel and McCoy indeed suggest[26] that what may have been most "abusive" about steering was that lenders set floor or reservation interest rates and other terms for particular borrowers based on the borrower's home equity and credit score, and then tried to get borrowers to take subprime type loans that had the highest rate. That is, that lenders used the flexibility afforded by subprime loans to price discriminate across borrowers based on the risk of default posed by a particular borrower. Lenders did not reveal to borrowers the minimum price that they would charge a particular borrower.[27]

With YSP compensation, the amount a lender paid to a mortgage broker (or other loan originator) depended positively upon the rate paid by the borrower. The higher the interest rate that the broker persuaded the borrower to pay, the higher was the broker's compensation.[28] So pernicious did the supporters of Dodd-Frank find YSP's that the law flatly and expressly bans this form of compensation.

To Dodd-Frank supporters, both steering and YSP's are "kickbacks," and an attempt to "rip-off" borrowers with "high cost" products.[29] However, to anyone accustomed to market transactions, neither steering nor YSP compensation should seem at all surprising. Steering, especially in its fine-tuned form, was clearly an attempt by sellers of a product – mortgage lenders – to charge as high a price as possible for their product above the perceived cost of providing it. And YSP's were a way to incentivize

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[23] As observed previously by Jonathan Macey, Geoffrey Miller, Maureen O'Hara, and Gabriel D. Rosenberg, Helping Law Catch up to Markets: Applying Broker-Dealer Law to Subprime Mortgages, 34 J. Corp. L. 789, 796 (2009).

[24] The type of subprime loan that I describe here is known as a "short term hybrid"; this type of subprime loan made up 75 per cent of all subprime mortgages written during the 2003-2007 period. Christopher Mayer, Karen Pence, and Shane M. Sherlund, 23 J. Econ. Perspec. 27, 30 (2009).

[25] I take this summary description from Macey et al. supra note __ at 801.

[26] Engel and McCoy, supra note __ at 29, 32.

[27] Engel and McCoy, supra note __ at 32.

[28] Engel and McCoy, supra note __ at 32.

[29] Engel and McCoy, supra note __ at 32.

salespeople to bargain to maximize this price. That sellers attempt to get as high a price as possible for their product is one of the core facts about market behavior. The opposing core fact is that buyers attempt to pay as little as possible, and will pay no more than their reservation prices. In thick markets, buyers win, as competition forces sellers to lower price down to the level of their costs. In other words, in normal market behavior, sellers would like to charge high prices, but buyers shop and search and investigate market alternatives, and end up paying competitive prices that are determined by seller cost, rather than by their own willingness to pay.

For steering and YSP compensation to have incited the degree of outrage that they did among Dodd Frank supporters, it must be that those supporters had little faith in the buyer protective ability of market mechanisms. But what would be the grounds for such skepticism about markets? Dodd Frank advocates themselves have described a frenzied, highly competitive subprime lending market during the housing boom, a market led by upstart entrants and only later entered by the giant banks.[30] From all that we know, borrowers had all kinds of options during the housing boom, and could have easily shopped for loan offers. Dodd Frank supporters emphasize the way in which lenders targeted their most aggressive marketing tactics at relatively poor and uneducated people in minority, black and Hispanic neighborhoods,[31] and the Dodd Frank law specifically authorizes the Federal Reserve to ban "abusive" leaning practices that "promote disparities among consumers of equal creditworthiness but of different race, ethnicity, gender and age."[32]

The fact that some lenders were indeed targeting minority areas is likely explained in part by economic and in part by legal and political factors. Lenders faced enormous and continuing legal and political pressure upon them to increase the number of home loans made in such areas. Economic factors also surely played a large role in the marketing of subprime loans. Not all people are equally comfortable with or good at bargaining. There is evidence that during the housing boom, minority subprime borrowers were charged higher fees or rates than whites with similar credit scores.[33] There is, more generally, evidence that differences in bargaining ability do indeed correlate with race, age and gender as well as with income and education. In bargaining, strategic weakness is revealed and exploited, and if strategic weakness happens to correlate systematically with various demographic variables, then it is true that bargaining will generate outcomes that differ systematically with these demographic variables.

However, absent some collusion among lenders, the fact that lots of lenders were attempting to make subprime loans to minority borrowers would tend to make the market for such loans among minorities even more competitive than among other social groups. But Dodd Frank is not designed to cure market imperfections so that competitive markets can achieve their theoretical promise. The practices Dodd Frank supporters call "predatory" or "abusive" are not pathologies of market failure, but rather precisely what one would have expected to see in a hyper-competitive market bubble fueled by easy credit. Dodd Frank is not about fixing markets, it is about replacing them.

[30] Engel and McCoy, supra note __ at 19-29.
[31] Engel and McCoy, supra note __ at 30.
[32] Dodd Frank Act Section 1403.
[33] Engel and McCoy, supra note __ at 30.

Dodd Frank replaces markets both through its prohibition on "abusive" practices generally and specific per se abusive practices, and through the "reasonable ability to repay" obligation that it imposes upon consumer lenders. I shall argue that this "ability to repay" obligation is based on a model -- the suitability standard imposed on broker/ dealers in securities law -- that itself is apparently soon to be replaced with a fiduciary standard, and which in any event is likely to be much different when applied by the CFPB to lenders making mortgages than it has been when applied to brokers recommending securities transactions.

Before getting to these issues regarding the likely evolution of Dodd Frank's suitability standard, it is worthwhile to pause for a moment to consider whether such market replacement is really necessary.

III. Evaluating The Purported Economic Justifications for Eliminating Abusive or Subprime Lending

There are a number of economic justifications for Dodd Frank's attempt to eliminate so-called abusive or predatory lending, but when closely and carefully evaluated, few of them turn out to be very persuasive.

Dodd Frank's macroeconomic story is that subprime, risky lending fueled the housing boom. There is indeed evidence that securitization of mortgages had an impact in increasing the supply of credit to subprime or high-risk borrowers,[34] and evidence that an increase in the supply of subprime lending increased prices in certain areas.[35] But there is also evidence supporting the opposite causal relationship: that the volume of subprime lending increased only after sustained housing price increases raised expectations about future house price increases.[36] There are serious statistical problems in the attempt to untangle the direction of causality (including how to measure the impact of past prices on expectations of future prices).[37] The only thing we know for sure is that when mortgage rates and delinquencies rapidly spiked in 2005, subprime lending abruptly slowed and ceased entirely by 2007.[38]

In any event, evidence about changes in the volume of subprime lending is not the same thing about changes in the volume of mortgage contracts sold in ways and with terms that Dodd Frank regulates. Dodd Frank's story about how consumers were harmed by predatory lending presumes that i) consumers were persuaded by predatory lenders to take out loans that they do not understand and which ii) they had a low chance of actually being able to repay, therefore making it likely that iii) the lender would eventually foreclose on the home financed by the loan, causing enormous harm both to the borrower and to other people who were not parties to the mortgage contract.

[34] Atif Mian and Amir Sufi, The Consequences of Mortgage Credit Expansion: Evidence from the U.S. Mortgage Default Crisis, 124 Quart. J. Econ. 1449 (2009).
[35] See, e.g., Anton Pavlov and Susan Wachter, Suprime Lending and Real Estate Prices, 39 Real Estate Econ. 1 (2011).
[36] Major Coleman IV, Michael LaCour-Little and Kerry D. Vandell, Subprime Lending and the Housing Bubble: Tail Wags Dog?, 17 J. Housing Econ. 272 (2008).
[37] Jan K. Brueckner, Paul S. Calem, Leonard I. Nakamura, Subprime Mortgages and the Housing Bubble, 71 J. Urban Econ. 230 (2012).
[38] See Mayer et al. supra note __ at 28.

As for the first two points, there are economic models of how a lender can (fraudulently or non-fraudulently) persuade borrowers into taking out harmful loans.[39] There is also evidence that many sub-prime borrowers did not understand even basic terms of their mortgage loans. This evidence comes from a natural experiment that took place in Chicago between 2005 and 2007. The natural experiment was an Illinois law that implemented a pilot program mandating credit counseling for high-risk borrowers in certain areas of the city before such borrowers took out mortgage loans. The credit counselors discussed and explained the terms of specific mortgage loan offers. One of the most remarkable things found by the counselors during the 2005-2007 Chicago pilot program was that an "overwhelming majority" of borrowers with adjustable rate mortgages who were counseled did not understand that their mortgage rates were not fixed.[40]

This theory and evidence is consistent with the standard story about abusive lending. What is not consistent with the standard story is recent and much broader and more systematic empirical evidence about just what sort of borrowers during the housing boom took out the kind of complex subprime mortgages that Dodd Frank prohibits. In a study of over 10 million mortgage loan contracts originating between 2003 and 2007, Amromin and colleagues[41] found that even within particular geographic areas (and controlling for other state-specific effects), it is households with higher income and higher credit ratings who chose complex sub-prime types mortgages. Moreover, it was precisely such relatively well-off and well-educated households who tended to prefer loans with little or no required documentation. As Amromin and colleagues conclude, "there is little evidence that a typical complex mortgage is taken out by poor and naïve households that are more prone to predatory lending."[42]

The evidence also suggests that such relatively high income and well- educated people were taking out complex subprime loans in order to get the funds to buy houses that were very expensive relative to their income. Such behavior was especially prevalent in markets where house prices and population had been rising.[43] The natural inference is that lots of relatively well-educated and well-off people had decided that house prices and income were both likely to continue to rise in the future, making it rational to take out a very big mortgage loan that carried very low payments in the near future. Before rates would rise, borrowers could sell the home, pay off the loan, and move on to an even bigger house.

Such loans were, of course, subject to a high risk of default in the event that expectations of rising prices turned out to be wrong. As economic theory would predict, lenders used prepayment penalties – a feature of subprime loans often singled out for special opprobrium by Dodd Frank supporters – to control for and lessen risk on subprime loans. To be more specific, there is evidence that prepayment penalties in

[39] Daniel Morgan, Defining and detecting Predatory Lending, Federal Bank of New York, Saff Report No. 273 (2007) (fraud); Philip Bond, David K. Musto, and Bilge Yilmaz, Predatory Mortgage Lending, 94 J. Fin. Econ. 412 (2009) (use of asymmetric information to persuade).

[40] Sumit Agrawal, Gene Amromin, Itzhak Ben-David, Souphala Chomsisengphet, and Douglas D. Evanoff, Predatory Lending and the Subprime Crisis 9, Ohio State University Dice Center WP 2012-8 (2012).

[41] Gene Amromin, Jennifer Huang, Clemens Sialm and Edward Zhong, Complex Mortgages, NBER Working Paper No. 17315 (August, 2011).

[42] Amromin et al, supra note __ at 17.

[43] Amromin et al. supra note __ at 17-18.

variable rate mortgages have strong incentive effects, in that they discourage prepayment,[44] and correspondingly significant impacts in lowering both lender risk and the interest rate charged to borrowers.[45]

Still, there is no question but that some poor, high risk households took out subprime loans during the housing boom, and that some such households defaulted on these loans. Interestingly, however, evidence from the Chicago pilot program referred to earlier indicates that delinquency and default may have little to do with the type of mortgage loan. The Chicago program required high risk (low credit score) borrowers in the program areas to attend credit counseling if they were considering choosing a high-risk mortgage. (And all borrowers were required to attend counseling if choosing an especially high risk mortgage, those with negative amortization, prepayment penalties or high closing costs). The program had a dramatic impact in reducing the supply of high risk mortgages, with about half of the lenders specializing in high risk mortgages exiting the market when the program began. Borrower default rates, however, fell by only 3.6%, which – accounting for the change in loan types and overall default rates – leads Agarwal and colleagues to estimate that predatory loans had an 18 month default rate about 6% higher than the non-predatory loans.[46]

Foote et al. present remarkably similar evidence drawn from a larger, national dataset.[47] They find that 53 per cent of subprime adjustable rate mortgages (ARM's) originated between 2005 and 2007 experienced at least one 90 day delinquency, but 48 per cent of fixed rate subprime mortgages originated during that same period experienced such a delinquency. An increase of 6 (Amromin et al.) or 5 (Foote et al.) percentage points in delinquency rates does not suggest that the relatively more complex adjustable (and sometime negative amortization) mortgages had much to do with defaults on subprime mortgages and the housing boom's collapse.

And these delinquency rates must be put in context. Despite the unprecedented housing collapse and Great Recession, the evidence shows that the vast majority of subprime loans made from 2000 to 2005 were win-win deals for both lender and borrower. After two years, more than 80 per cent of loans made before 2006 to the highest risk borrowers -- those with credit scores below 620 and who often had histories of "serious debt repayment problems" – had either been repaid or at least avoided serious delinquency.[48]

Thus as to the first two prongs of the Dodd Frank justification – that abusive lenders targeted vulnerable population and persuaded them to take out loans that they could not repay – the existing evidence seems to be that while this sort of abusive lending did take place, it was not nearly as pervasive or important as Dodd Frank supporters seem to believe. The final part of the Dodd Frank justification is that such lending led to harmful foreclosures. Foreclosures are harmful, on this argument, both to the

44 Michelle A. Danis and Anthony Pennington-Cross, 60 J. Econ. & Bus. 67 (2008).
45 Gregory Elliehausen, Michael E. Staten and Jevgenijs Steinbucks, The Effect of Prepayment Penalties on the Pricing of Subprime Mortgages, 60 J. Econ. & Bus. 33 (2008).
46 Agarwal et al., supra note __ at 30.
47 Christopher L. Foote, Kristopher S. Gerardi and Paul S. Willen, Why did so Many People Make So Many Ex Post Bad Decisions? The Causes of the Foreclosure Crisis, Fed. Res. Bank of Boston, Discussion Paper No. 12-2 (version of July 20, 2012).
48 Foote et al., supra note __ at 8.

homeowners who default and suffer foreclosure, and to communities in which foreclosure is widespread. One would think that the first issue is primary: whether people who suffer foreclosure are actually harmed. But economists have focused their research mostly on the second question. The reason for attention to the second question is that many people have claimed that the social cost of improvident lending during the boom was the post-boom devastation suffered by communities with large numbers of (especially subprime) foreclosures. This devastation is said take the form not only of reduced home prices and the consequent eventual reduction in local property tax revenues and public goods spending, but also of neighborhoods blighted by vacant and damaged homes. In perhaps the most careful study of the effect of foreclosures on home prices, Campbell and colleagues find that while the prices of foreclosed homes do indeed fall, there is little impact of foreclosure on prices of other homes in the same zipcode. However, at the level of the neighborhood – within a mile or a tenth of a mile of the foreclosed property – there are significant and persistent negative spillover effects on home prices.[49]

This evidence supports the common sense intuition that foreclosure per se is not to blame for falling house prices: prices fall because they rose too far too fast. Cities and towns that thought they could afford luxury public goods and services (and ultra-generous public employee pensions) found out that they could not. As for the highly localized negative spillover effects of foreclosures, from evidence that such spillover effects are bigger for single family homes than for condominiums and bigger too in poorer neighborhoods, Campbell and colleagues speculate that the negative spillovers are due to vandalism of vacant homes.

If, however, Campbell and colleagues are correct, then it seems odd to say that foreclosure has caused negative local spillovers. Regardless of why homes are vacant, vandalism of vacant homes, especially if widespread, causes decreases in the prices of nearby homes. The social problem is vandalism of vacant homes in poor neighborhoods. It is true that if there had been no housing boom, then there would have been fewer new houses in poor areas, and hence fewer vacant homes after the end of the boom. But this would be true also of any economic boom that increased the demand for and supply of housing in an area, but which then ended, leaving an increase in total housing supply but also temporary vacancies and vandalism. If economic conditions in the locality improve, then houses that are vacant and vandalized today may be purchased, renovated and reoccupied tomorrow. Would we really say that because a person may lose her job and leave a vacant house that may be vandalized, that person generated an "externality" when she took out a risky loan to buy the house during times of economic prosperity? Would we impose a tax on home buyers equal to the expected negative externality that will result if and when they lose their job and vacate their homes?

Even if this rhetorical question persuades one that there is something not quite right about saying that predatory lending, by increasing future foreclosures, is somehow responsible for the negative local spillovers resulting from the vandalism of vacant homes, there remains the harm suffered by people who actually fall into default and lose their homes in foreclosure. While there is not yet much systematic evidence on the effects of foreclosure, the evidence that does exist suggests impacts much less severe than some might suppose. One recent study finds that while people who experience

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[49] John Y. Campbell, Stefano Giglio and Parag Pathak, Forced Sales and House Prices, NBER Working Paper No. 14866 (April, 2009) (forthcoming AER).

foreclosure do move at much higher rates than people who do not, about half of foreclosed-upon borrowers had not moved within two years after their property entered the foreclosure process. [50] Moreover, while people move to rental apartments (multi-family dwellings) after losing their homes in foreclosure, those apartments are of roughly the same size and quality of their previous single family homes and are in very similar (not appreciably worse) neighborhoods. There are other effects of foreclosure – children, for example, may have to change schools – but the systematic empirical evidence presented thus far suggests nothing beyond the obvious: that foreclosure itself causes people to move to rental apartments. Compared with the events that cause default and foreclosure – losing one's job due to an economic downturn or the misfortune of severe and lasting illness or the death of a spouse -- foreclosure per se would seem to cause little harm.

IV. Dodd-Frank's Suitability Standard

The foregoing analysis and review of the evidence pertaining to housing loans suggests that in targeting abusive or "predatory" consumer lending, Dodd Frank may well have been based on a misunderstanding of the nature, extent and consequences of the behavior targeted. Still, however, wrongheaded, Dodd Frank has replaced arms length bargaining in consumer lending with a new "reasonable ability to repay" standard for consumer loans. This standard is, intentionally, very similar to the "suitability" standard that applies to broker/dealers under the federal securities law; indeed, the imposition of a suitability standard for residential mortgages was suggested many years before the Great Recession. [51] For this reason, I shall refer to Dodd Frank's "reasonable ability to repay" standard as a suitability standard.

a) Suitability in Securities Law

Dodd Frank's suitability standard is modeled after the suitability standard that governs broker/dealers in their interactions with retail investors. As succinctly described by Macey and colleagues, "the suitability doctrine requires broker-dealers to tailor the securities sold to a customer with that customer's specific needs and objectives, and forbids agents from simply pushing those products that offer the greatest profit margins for the seller."[52] As this statement indicates, there are two parts to the securities law suitability obligation of brokers and dealers. The first obligation is to ensure that investments are suitable for clients. In practice, this has meant rules (promulgated by the Financial Institution Regulatory Authority and the New York Stock Exhange, or emerging from litigation under Rule 10b-5[53]) that prevent brokers from marketing speculative or, more generally, stocks and other investments that are too risky given the investor's profile and objectives.[54] This rule has been interpreted, for example, to restrict

[50] Raven Molloy and Hui Shan, The Post-Foreclosure Experience of U.S. Households, Federal Reserve Board of Governors, Finance and Economics Discussion Series No. 2011-32, pp. 16-18. (May, 2011).
[51] Daniel S. Ehrenberg, If the Loan Doesn't Fit, Don't Take It: Applying the Suitability Doctrine to the Mortgage Industry to Eliminate Predatory Lending, 10 J. Affordable Hous. & Cmty. Dev. L. 117, 130 (2001).
[52] Macey et al., supra note __ at 815.
[53] For more details on the rules, Macey at al., supra note __ at 816-819.
[54] Donald C. Langevoort, Brokers as Fiduciaries, 71 U. Pitt. L. Rev. 439, 444 (2010).

brokers from investing customers' funds in margin accounts.[55] Importantly, moreover, the rule prevents brokers from recommending unsuitable securities to a customer even if all the risks of the security are disclosed and the customer specifically says the she want to make the investment.[56]

The other aspect of the securities suitability standard is its regulation of the fees charged by a broker and hence the costs incurred by customers.[57] Brokers usually are paid by getting a commission on each trade that they execute for a customer. This creates a temptation for brokers to make a large numbers of trades simply to generate fees. The suitability standard clearly prohibits brokers from "churning," which is defined as making a recklessly or fraudulently making an excessive number of trades, given the customers' objectives. [58]

Beyond this prohibition on churning, however, the suitability standard does very little to regulate the costs of investing with a broker. A broker has no obligation to offer the "best available" securities, or to choose the package of securities with a given risk/return profile that minimizes the cost incurred by customer.[59] Brokers can invest their customers into mutual funds that charge up-front loads even when there are comparable funds without such loads, funds who have paid them fees to be featured (so-called "shelf space" arrangements), and proprietary funds sponsored by the broker's firm.[60]

b) From Suitability to Fiduciary Duties in Securities Law

The sponsors of Dodd Frank were indeed concerned that the suitability standard was not enough to adequately protect retail investors, and Section 913 of Dodd Frank required the SEC to study whether that standard should be strengthened, in particular to regulate securities brokers and dealers under the tougher fiduciary standard that has applied to investment advisors.

Traditionally, brokers delivered limited advice consisting of recommendations to clients as to whether or not to buy, sell or hold a particular stock, and also executed trades for clients. Dealers act in their own capacity, and brokers are acting in their dealer capacity when they sell stocks out of inventory, or sell proprietary mutual funds to clients, or buy stocks from clients.[61] Even if brokers provide advice in connection with a particular transaction, their compensation still comes from commissions on transactions. Investment advisers, by contrast, manage entire portfolios for individual and institutional clients, and provide a wide range of advice concerning investment strategies and portfolio composition.[62] Most investment advisors are very small, with fewer than six non-clerical employees, and the vast majority receive as their compensation a percentage of total assets under management.[63]

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55 Macey et al., supra note __ at 824-829.
56 Macey et al, supra note __ at 821.
57 See Langevoort, supra note __ at 445.
58 Macey et al, supra note ___ at 828-829.
59 Langevoort, supra note __ at 445.
60 Langevoort, supra note __ at 445-446, 448.
61 See SEC, Study on Investment Advisers and Broker-Dealers 10-11 (Jan. 2011).
62 SEC Study, supra note __ at 6-7.
63 SEC Study at 7.

Investment advisors have long been held to owe a fiduciary duty to their clients under the Investment Advisers Act.[64] This fiduciary duty includes both a duty of care and a duty of loyalty. The latter duty requires full disclosure to the client of any material information of any "conflict of interest which might incline an investment adviser – consciously or unconsciously – to render advice which [is] not disinterested."[65] An investment adviser's duty of care includes an obligation to ensure that investments are suitable given particular client's financial situation and investment objectives, advisers must ensure that their advertisements are not misleading, and must have an internal compliance program that ensures it they are in fact complying with fiduciary obligations.[66] Advisers must disclose to clients the method and amount of their compensation, as well as any other fees or costs charged to clients.[67]

Generally, and unlike investment advisers, broker/dealers have actual fiduciary obligations to clients only where the broker has been entrusted with discretionary authority over the client's account,[68] and so is essentially acting to manage the account as does an investment adviser. However, in a number of studies and surveys, the SEC has discovered (to no one's great surprise) that ordinary people do not understand the difference between a broker and an investment adviser and seem completely unaware of the different legal standards applying to broker/dealers versus investment advisers.[69] Moreover, many commentators recommended to the SEC a uniform fiduciary duty applying to both investment advisers and brokers, and in 2011, the SEC Staff recommended the adoption of a uniform standard. Applying to any investment advisor or broker "providing personalized investment advice about securities to customers," the standard is a fiduciary standard in that it requires that the broker or adviser providing such advice "act in the best interest of the customer, without regard to the financial or other interests of the broker, dealer, or investment adviser providing the advice."

The rationale for the SEC's uniform fiduciary standard is not a mass of empirical evidence indicating new problems with broker-client relations. Instead, it was in part the market expansion of brokerage firms into charging so-called "wrap fees" for a package of ongoing brokerage, research and advisory services very similar to what investment advisors have traditionally provided. [70] Regulators also apparently wanted a standard that they could invoke to require greater disclosure of sales practices that do not involve fraud but arguably create a conflict of interest.[71] However, Dodd Frank itself permits brokers to continue to be paid by commissions, and does not require a continuing duty of loyalty or care to customers after providing personalized investment advice.[72] What the SEC Staff recommendation seems to contemplate is increased disclosure by broker/dealers at the outset of the relationship with a particular customer. What should be required (by regulation) is a "uniform, simple and clear" disclosure by the broker of the terms of her

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[64] SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 194 (1963).
[65] SEC v. Capital Gains, supra note __ at 82.
[66] SEC Study, supra note __ at 28-37.
[67] SEC Study at 38-40.
[68] U.S. v. Skelly, 442 F3d. 94, 98 (2d Cir. 2006).
[69] SEC Study, supra note ___ at 94-101.
[70] Omnig H. Dombalagian, Investment Recommendations and the Essence of Duty, 60 Amer. U. L. Rev. 1265, 3111 (2011).
[71] Dombalagian, supra note __ at 1313.
[72] See SEC Study, supra note __ at 112-113.

relationship with the client, the services provided by the firm, how it charges, and any conflicts of interest.[73] Principal trading is still to be allowed, but regulations should define the "personalized investment advice" to include the making of a stock purchase (or sale) recommendation by a broker.[74] The Commission Staff also recommends that the SEC continue with its program to educate and improve the financial literacy of retail investors.[75]

These SEC staff recommendations call for new Commission guidance and rulemaking on questions such as conflicts of interest in principal trading by brokers and advisers.[76] This is consistent with the advice given by some commentators that the Commission not simply impose a fiduciary duty on brokers and simply leave its meaning to case by case determination.[77]

c) Brokers, Advisers and Investment Performance

Perhaps unsurprisingly, there is systematic empirical evidence that investors who use brokers pay substantially higher fees.[78] More surprisingly, there is evidence that the funds to which brokers direct their customers have lower risk-adjusted returns (relative to directly placed funds) and are no better at asset allocation.[79] This evidence is matched by evidence from Germany showing even when one takes account of client characteristics that may influence the choice to employ a financial adviser, brokerage accounts managed by independent financial advisers not only generate systematically lower average monthly returns but also lower risk-adjusted returns (as measured by the Sharpe ratio) relative to returns on self-managed accounts.[80]

This evidence cannot be taken as showing that people are foolish to rely upon brokers' recommendations or advisers' continuing advice. It is always possible that the people who choose to use brokers or advisers would do even worse if they managed their own investments. The study by Hackethal et al.[81] is the only one of which I am aware that attempts to control for a self-selection effect – that some types of people, females and older people, are more likely to use brokers or advisers than other types of people, males. But the real self-selection effect may be that people who are financially able and enjoy managing their investments do so, while those who lack financial literacy and/or get substantial disutility from investment management farm out decisions to brokers or advisers. If this is true systematically, then it may be hard to ever get any statistically significant results on the returns from self-managed portfolios that are managed by people who do not want to be managing their own portfolios.

There is, to be sure, plenty of evidence that people who do manage their own portfolios (who tend to be male) exhibit certain systematic patterns of sub-optimal

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[73] SEC Study, supra note __ at 116-117.
[74] SEC Study, supra note __ at 126-127.
[75] SEC Study, supra note __ at 128-129.
[76] See SEC Study, supra note __ at 120.
[77] See Langevoort, supra note ___ at 454-455.
[78] Daniel Bergstresser, John M.R. Chalmers, Peter Tufano, Assessing the Costs and Benefits of Brokers in the Mutual Fund Industry, 22 Rev. Fin. Stud. 4129 (2009).
[79] Bergstresser et al., supra note ___.
[80] Andreas Hackethal, Michael Haliassos and Tullio Jappelli, Financial Advisers: A Case of Babysitters?, 36 J. Banking & Fin. 509 (2012).
[81] Hackethal et al, supra note ___.

investment. These include the tendency to sell winners and keep losers,[82] to engage in excessively many trades,[83], chase trends, and fail to rationally infer managerial skill from past performance.[84] These sorts of findings have been explained as examples of individual investors behaving in ways not predicted by standard economic theory. For example, hanging on to losers and selling winner is explained by asymmetric treatment of gains versus losses (prospect theory); excessive trading is explained by investor overconfidence.

All in all, the existing research seems to reveal an inevitable tradeoff. If an investor manages her own portfolio, then she is in a sense gambling on her own rationality and financial knowledge, but can at least be confident that the person who is managing her investments is acting to further the owner's self-interest. If the investor delegates management to a broker or investment adviser, then she is gambling that the broker or adviser will really do her best to discern and best serve the investor's interests, and she is gambling also that the broker or adviser investor actually has superior financial knowledge and judgment and can generate better risk-adjusted returns. The decision to employ a broker or adviser thus always adds an additional element of risk: that arising due to a conflict of interest between the broker or adviser and the client. As for broker or adviser skill, if the Great Recession has taught financial economists anything, it is that there is no simple, universally agreed-upon way to optimally diversify a portfolio. The question of how to optimally diversify a portfolio is an area of active and ongoing research that may never supply one simple answer.[85] Even more disturbing, perhaps, there is no agreed-upon method of assessing mutual fund performance to discern distinguish truly outperforming funds form those that outperform during some sample periods just due to chance.[86]

By revealing that most advice given even to sophisticated investors over the period 2002-2008 was based on fundamental errors going to the basic nature of risks carried by alternative investments, the Great Recession ought to have cut the demand for advice by brokers and investment advisors. But of course the questions of interest for purposes of this paper are whether the differential legal treatment of brokers versus investment advisors in American law has had any impact on the relative risk-adjusted returns earned by clients of brokers versus investment advisers, and whether there is reason to think that the move to a unified fiduciary standard well somehow improve the welfare of the investors who choose brokers. Unfortunately, financial economists have not provided evidence that sheds light on either of these questions. Theoretical work on

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[82] Terrance Odean, Are Investors Reluctant to Realize their losses? 53 J. Finance 1775 (1998).

[83] Terrance Odean, Do Investors Trade too Much?, 89 Amer. Econ. Rev. 1279 (1999); Brad M. Barber and Terrance Odean, Boys will be Boys: Gender, Overconfidence, and Common Stock Investment, 116 Quart. J. Econ.261 (2001). Excessive trading has been shown to generate large losses for individual investors. See Brad M. Barber, Yi-Tuung Lee, Yu-Jane Liu, Terrance Odean, Just how Much Do Individual Investors Lose by Trading?, 22 Rev. Fin. Stud. 609 (2009).

[84] Warren Bailey, Alok Kumar and David Ng, 102 J. Fin. Econ. 1 (2011).

[85] See, e.g., Victor DeMiguel, Lorenzon Garlappi Francisco J. Nogales, Raman Uppal, A Generalized Approach to Portfolio Optimization: Improving Performance by Constraining Portfolio Norms, 55 Manage. Sci. 798 (2009); Heiko Jacobs, Sebastian Müller, and Martin Weber, How Should Private Investors Diversify? An Empirical Evaulation of Alternative Asset Allocation Policies to Construct a "World Market Portfolio," Mannheim, 2009;

[86] Laurent Barras, Oiliver Scaillet, and Russ Wermers, False Discoveries in Mutual Fund Performance: Measuring Luck in Estimated Alphas, 65 J. Fin. 179 (2010).

the topic is progressing, but so far its main contribution is to formalize the insight that the incentive for a broker or adviser to act against her client's interest – as by putting her in overly risky investments or making too many trades – arises primarily because of the incentives created by the broker's compensation structure.[87] The existing suitability standard applied to brokers already seems well aware of this potential problem: the standard has pretty clear rules against churning and certain high risk investment strategies, such as the use of buying on margin.

d) The Likely Meaning of Suitability Under Dodd-Frank

The structure of the Dodd Frank law, along with the behavioral assumptions underlying it, provide quite a bit of guidance as to how the law likely will be implemented by the new CFPB. We can also make some tentative observations about the likely consequences of alternative regulatory approaches to the law's implementation.

The Dodd-Frank law itself provides some guidance as to how the new CFPB will develop the suitability ("reasonable ability to repay" standard). By creating a statutory safe harbor for traditional, fully amortizing, relatively low cost mortgages ("qualified mortgage loans") and prohibiting "steering" borrowers away from such loans to higher cost, riskier mortgages, the statute not only endorses "qualified" mortgages but suggests that mortgages which pose more risk than such "qualified" loans may presumptively fail the "reasonable ability to repay" test. Indeed, since the statute defines an "abusive" practice to include taking "unreasonable advantage" or a consumer's lack of understanding, inability to protect self-interest, or reasonable reliance, it would seem to invite the new agency to promulgate a series of rules codifying certain types of mortgage loans as per se "abusive," or at least establishing a very high burden of proof for any lender seeking to survive legal attack for making such loans.

While there is no systematic empirical evidence, it seem that the effect of the suitability standard for securities broker/dealers has been primarily to clearly prohibit a few practices, such as churning and (in some cases) buying stock on margin. Suitability, and even the proposed unified fiduciary standard, does not prohibit brokers from charging on their customary commission basis. Suitability as elaborated by Dodd Frank would seem likely to go much further. The law itself bans certain types of compensation structures, and not only requires regulation defining abusive practices but explicitly prohibits certain kinds of loans when there is a "qualified" mortgage alternative. Such regime is likely to do more than regulate markets for consumer mortgage loans. It is likely to supplant market-determined contract types and terms with a narrow set of contracts approved and written by regulators at the CFPB.

It may be argued that this outcome is not strictly required by Dodd Frank, that the law leaves open various regulatory alternatives. One alternative approach for the CFPB would be to require consumer lenders to engage in an individualized suitability inquiry similar to the duty of inquiry imposed on brokers. This suitability inquiry would require the lender to make its own determination of the borrower's ability to repay alternative loans, and would – as does the securities law suitability duty – prevent a lender from

[87] See, e.g., Roman Inderst and Marco Ottaviani, Misselling Through Agents, 99 Amer. Econ. Rev. 883 (2009); Roman Inderst, Consumer Protection and the Role of Advice in the Market for Retail Financial Services, 167 J. Inst. Theo. Econ. 4 (2011); Roman Inderst and Marco Ottaviani, How (not) to Pay for Advice: A Framework for Consumer Financial Protection (2011).

making unsuitable loans even if the borrower clearly and fully stated that she knew she was undertaking a risky loan but wanted to do so despite the risk.

Such a borrower-specific inquiry is expensive. Moreover, it is much less likely to provide a lender with legal protection than does the suitability inquiry imposed on brokers. The reason is that while the suitability requirement imposed by securities law is enforced primarily through arbitration, Dodd Frank's suitability requirement can be enforced in actions brought by state Attorneys General. Anytime a consumer borrower was declared in default on a loan type with terms that are arguably riskier than those of the "qualified" mortgage preferred by Dodd Frank, the lender would face almost certain litigation and substantial potential liability in litigation brought on behalf of all consumer borrowers in similar straits. Hence the borrower-specific suitability inquiry would have high costs but bring little benefit in terms of reduced liability.

If this is so, then lenders could well request, as guidance from the CFPB, relatively detailed regulations specifying precisely what sort of loans could be safely made to general categories of consumer borrowers. It might be quite detailed guidance, with consumer income, wealth, age and household size variables given in one column and allowable loan terms set out in other columns. Thus one could imagine a grid, similar to the grid used for government Social Security disability payments. The entire consumer lending process could be standardized. For any particular consumer-borrower, the maximum amount of the loan as well as its interest rate and other terms would be dictated by federal regulators. Consumers would have only one choice left, whether or not to take out a mortgage loan.

This analysis is, of course, speculative and informal, but its predictions have already begun to be borne out. The CFPB is reportedly considering issuing regulations that would effectively make high quality, low risk mortgage loans – deemed "qualified mortgages" -- immune from ex post legal challenge under Dodd-Frank. Loans that are riskier – in the sense that mortgagors are spending more than a threshold amount on all debt servicing, including car and credit-card debt – would not receive this regulatory safe harbor.[88] If such regulatory initiatives continue, it will be the CFPB, and not lenders, who determine the type of mortgage products that are offered to consumers. In a very real sense, the CFPB may end up not only regulating consumer residential mortgage markets but actually replacing those markets with a system in which lenders are essentially acting primarily as agents for the government. Lenders would not be competing for consumer mortgage business – because they would all be offering virtually identical products – but would instead be competing to retain their status, either implicit or explicit, as government-approved consumer lenders.

This might mean that consumer mortgage lending would become less profitable for lenders. But it might not. When the government imposes price ceilings on approved products and bans other type of products, it creates incentives for sellers to find or create new products whose prices are not capped. This is most clearly demonstrated by usury laws. These laws set maximum interest rates, but lenders have found a variety of ways to structure transactions, offering so-called non-traditional loans that are not covered by

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[88] See Alan Zibel and Maya Jackson Randall, Home Loans May Get Shield, Wall Street Journal, C1, Tuesday, October 16, 2012.

usury laws. Some such non-traditional loans, such as loan-sharking and pawnshops, entail their own serious set of social harms.[89]

Moreover, historically, government price ceilings have led to rationing and shortages.[90] In the case of consumer mortgage lending, the terms of the "qualified" mortgage would likely be such that many high-risk consumer borrowers – those with poor credit scores and less secure or more difficult to verify income streams – would not qualify. Assuming that the Dodd Frank regulations essentially prohibit the high interest rate, high fee mortgages that banks would actually be willing to write for high-risk borrowers, the supply of mortgages to high-risk consumer borrowers would decrease. On the other hand, banks could be required to write loans to some types of high-risk borrowers. Those high-risk borrowers living in areas covered by the Community Reinvestment Act, for example, might get mortgage loans, and they would get the loans with much lower interest rates and friendlier terms (e.g. a right to prepay) than would be extended by markets unregulated by Dodd Frank. But as noted above, the existing evidence is that default rates by high risk borrowers do not decline by much (around 6%) when they are steered ("counseled") to "safe," low cost mortgages. These costs would not simply disappear. Banks would pass them on to non-defaulting borrowers, who would pay higher interest rates and fees than otherwise. This would price out of the market some of the low income, high risk borrowers who Dodd Frank aims to help, and not just any such borrowers, but those who fully intend to make their payments as promised. Honest, non-strategic borrowers on the margin, in terms of credit score and income, would indeed be the ones most hurt by the more stringent credit screening that Dodd Frank's price ceilings would induce.[91]

V. Dodd-Frank's Significance, and Danger

It might seem surprising, but to many Dodd Frank advocates, none of these potential consequences of Dodd Frank just sketched are a cause for concern. Restricting and even eliminating the supply of certain kinds of "abusive" mortgages to consumers is justified, on the view of Dodd Frank supporters, by the stylized fact that a large number of consumers who took out such mortgages during the housing boom did so without a very good understanding of the terms of these mortgages. When those consumers defaulted, they suffered personal harm, and mass defaults generate serious and harmful spillovers that affected entire communities. Even worse, according to this justification, were the people who took out risky mortgage loans with deferred interest and principal payments and who then strategically walked away from their homes and the loans, voluntarily incurring the hit to their credit ratings in order to get out of failed speculative bets on home prices. The entire point of Dodd Frank, according to this view, is to rid the market of speculative, high-risk mortgages, regardless of whether or not consumers would want such mortgages were they offered.

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[89] See Todd Zywicki, Dodd Frank and the Return of the Loan Shark, Wall Street Journal __ (Jan. 4, 2011)
[90] For a brief survey, see Fiona M. Scott Morton, The Problems of Price Controls, Regulation 50 (2001).
[91] Joseph E. Stiglitz and Andrew Weiss, Credit Rationing in Markets with Imperfect Information, 71 Amer. Econ. Rev. 393 (1981).

Dodd Frank's greatest significance lies precisely in this clear rejection of the idea that consumers have the capacity to engage in arms-length market transactions regarding credit and investments. Under Dodd-Frank, stockbrokers are to become fiduciaries, with an enhanced duty to make simplified disclosures to their clients and to act strictly in their clients' interests, apparently regardless of whether the broker is providing continuous portfolio management versus episodic advice. Under Dodd-Frank, mortgage lenders are to make only a limited range mortgage loans that have been pre-approved by the CFPB as "suitable" and safe for consumers. Credit card issuers are, under Dodd Frank, severely restricted in the type of fees that they can charge. All businesses providing credit or any kind of investment services to consumers must simplify their products – eliminating features that might confuse or somehow cause consumers to pay more than they anticipated – and to clearly and simply disclose the terms of the new, simplified consumer financial products (or services).

Upon closer inspection, Dodd Frank contains two seemingly radically conflicting mandates. Inspired by dozens of studies by behavioral economists showing that consumers fail to attend to, are confused by and hence can be exploited using even minimal complexity in the terms of credit and investment contracts, the law requires contractual and product (or service) simplification. On the other hand, Dodd Frank imposes enhanced duties on the providers of consumer financial and investment products to make sure consumers are choosing appropriate products and to act only in the interests of their consumer clients. In a world where consumers are heterogeneous, with not only different levels of wealth, income and education but also different attitudes toward risk and goals for their future, the two mandates – to simplify products while ensuring that consumers get the right product – inevitably conflict. With wide variation in consumer types, fitting the product to the consumer requires a wide variety of products. This is precisely what consumer credit and investment markets provided prior to Dodd Frank. It would seem flatly inconsistent to severely limit the range of permissible consumer financial products while at the same telling the providers of those products that they must find the product that is best for each individual consumer. But this is precisely what Dodd-Frank does.

Dodd Frank's intellectual champions have a ready response to this charge of inconsistency. Their response repeats what is the core policy implication of behavioral economics: that left to their own devices, consumer credit and investment markets provide products and services that are too complex, providing complexity that does not satisfy consumer preferences but takes advantage of consumer cognitive limitations. In the post Dodd Frank world, the CFPB will determine the optimal degree of complexity, or at the very least eliminate contract terms that consumers generally cannot understand and which end up surprising consumers and making them worse off than if they not entered into the contract in the first place. It is from this menu of simplified, non-exploitive contract types that providers of consumer credit and investment products may choose. By restricting the available contractual options that providers of consumer financial credit and investment products can provide to those that are non-exploitive, the post Dodd-Frank world is guaranteed to be one in which providers of such products do indeed act in the interest of consumers, rather than in their own interest in profiting from consumer mistakes. As an incentive, the post Dodd Frank world will seemingly offer immunity from liability to providers of government-approved consumer financial products and services.

The response of Dodd Frank champions is much too facile. A full analysis of whether Dodd Frank will in fact make consumers of financial and investment products better off is complex, but it must at least take account of the following.

A. Nudges become Bans and Restrictions in the Real World of Massive Potential ex Post Liability.

It is probably true that Dodd Frank would have passed even if there had never been a "behavioral" movement in economics, but the work of behavioral economists such as Richard Thaler and lawyers such as Cass Sunstein[92] has at the very least provided a serious scholarly pedigree for Dodd Frank's interventions into the world of consumer financial contracts. Behavioral economics experiments have revealed that people have preferences that are different than what economists have typically assumed: that they are concerned more with fairness than just maximizing gain, that they are very impatient and discount the future by a lot (myopia), that they care about their relative standing more than just about their absolute wealth or income, and, most famously, that the disutility they attach to potential losses is greater than the utility they attach to equivalent potential gains (loss aversion). Even more seriously, behavioral economics experiments have shown that people do not optimally calculate things like probabilities, so that they make all kinds of cognitive errors are not able to make the choices that are best for them given their preferences.

The most highly publicized implication of these behavioral economic findings for the design of consumer financial protection policy has been that regulators should require that consumer financial contracts be designed so as to help consumers avoid making contracts that are bad for them. For example, it is generally believed that people contribute too little to their defined contribution retirement benefit plans. A number of attempts have been made to educate workers so that they are informed as to the benefits offered to them through such plans, but even with the most obvious choices – such as giving a 60 year old worker a chance to match an employer's contribution, with the freedom to withdraw the doubled amount anytime without penalty – workers do not seem to save rationally.[93]

As an alternative to such failed attempts to educate people about the benefits of saving more, behavioral economists developed a (trademarked) program called Save More Tomorrow designed to nudge them into saving more. Save More Tomorrow automatically enrolls covered retirement pension plan participants in a program where they precommit to save an increasing percentage of their income every time they get a

[92] Richard H. Thaler and Cass R. Sunstein, Nudge: Improving Decisions about Health, Wealth and Happiness (2008).

[93] This experiment is reported by Richard H. Thaler and Shlomo Benartzi, The Behavioral Economics of Retirement Savings Behavior (AARP Public Policy Institute 2007).

raise. The plan is based on the core behavioral economic experimental findings of myopia and loss aversion briefly described above, plus the experimentally observed tendency of people to avoid changing established behaviors (inertia) and to evaluate losses in nominal as opposed to real dollar terms. As explained by its developers, Benartzi and Thaler:

> "[b]y synchronizing pay raises and savings increases, participants never see their take-home amounts go down, and they don't view their increased retirement contributions as a loss. Once someone joins the program, the saving increases are automatic, using inertia to increase savings rather than prevent savings. When combined with automatic enrollment, this design can achieve both high participation rates and increased saving rates."[94]

Thaler and Benartzi report that this plan dramatically increased savings rates.

Of course, an older person who was "nudged" by Save More to dramatically increase the rate at which they put retirement savings into a widely recommended S&P 500 Index fund in around 2007 would still be looking at a serious loss of money as of late 2012. As I conclude below, if people are going to be "nudged" into doing things that they would not otherwise do then it would seem to be awfully important that the nudgers not only serve only the best interest of nudgees but also actually can improve upon nudgee outcomes.

When it comes to mortgages, behavioral law and economics recommends requiring disclosures that clearly distinguish between fees and interest charges. A total figure for fees would be disclosed, as well as extensive information on interest rates – including when, why and by how much rates could change – with an interest payments schedule. The idea is that the information provided by such detailed disclosure could then be used by third parties, who would develop online services that would allow mortgage borrowers to clearly compare the cost of alternative mortgages offered by competing lenders. [95] There would be no need for borrowers to actually meet personally with a mortgage broker or banker as all information and shopping could take place online.

Shortly, I shall discuss whether and how such behavioralist proposals differ from more straightforward, non-behavioral proposals to craft better disclosures to mortgage borrowers.   The more immediate point to see is that Dodd Frank is already becoming a very different system than the behavioralists' ideal.   The law did give the discretion to the CFPB to implement some behavioralist ideas, such as requiring much clearer disclosure of up front costs and fees, and requiring that consumers be offered a no-points mortgage alternative.   However, the statute also flat out banned some mortgage contract provisions – such as mandatory arbitration provisions and yield-spread premium broker compensation. And if I am correct in my analysis and current regulatory trends continue, mortgages deemed "safe" and "simple" by regulators will be protected from ex post legal challenge. The impact of such safe harbors will not be to nudge *consumers* into the safe

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[94] Thaler and Benartzi, supra note __ at 21-22.

[95] See Thaler and Sunstein, supra note ___ at 137-138.

harbor mortgage contracts, but do incentivize *lenders* to offer only those safe harbor contract types.

The reason is liability. The behavioralist account focuses on how lenders take advantage of cognitively limited consumers, and it suggests reforms such as required disclosures that should in theory steer such consumers toward better choices. But in the actual Dodd Frank regulatory world, lenders will have to decide between allowing consumers to choose between such better, government approved and liability-free (or safe harbor) mortgages and other, non-approved potentially liability triggering mortgages (unprotected mortgages). For profit-maximizing lenders to choose to offer consumers both the liability free and liability-carrying mortgage, it must be that the potential additional revenue to them from the liability-carrying mortgage offsets the potential additional liability. A government endorsement of the liability-free mortgage, however, makes it very likely that state attorney generals – given enforcement authority under Dodd-Frank – will succeed in challenging the unapproved mortgages. A natural baseline for computing the damages to consumers from the sale of such unprotected mortgages is the additional charges paid relative to the approved mortgages. With such a baseline, and high probability of liability, it would seem that most lenders would stick with the safe harbor mortgages.

B. There will be an inevitable direct loss to some consumers from the contractual restrictions imposed by Dodd Frank.

To see this point most clearly, consider the category of negative amortization of mortgages so disfavored by Dodd-Frank. These products, such as interest only mortgages and option adjustable rate mortgages (ARM's), allow the borrower to make very low payments early in the life of the loan, thus actually increasing the balance owed on the loan. These loans have been popular with consumers not just during the housing boom of 2002-2006, but for decades. These alternative mortgages arose in the high inflation environment of the 1980's. At that time, nominal mortgage interest rates were extremely high, reflecting high expected future inflation. High nominal rates meant high payments on conventional fixed rate loans, and such high payments priced many households out of the housing market. Most seriously, households who had high expected future income relative to present income were effectively prevented from borrowing and matching their home purchase to their lifetime expected income.[96] Adjustable rate mortgages such as option ARM's that allow the postponement of the full interest due on the mortgage were a way for consumers to lower the near-term real interest rates on their mortgages. These mortgages allowed households facing borrowing constraints – typically younger and/or poorer households – a way to finance home purchases that they otherwise could not make in an environment with very high expectations of future inflation.[97] Alternative mortgages thus allow households to smooth their housing

[96] See Kristopher S. Gerardi, Harvey S. Rosen, and Paul S. Willen, The Impact of Deregulation and Financial Innovation on Consumers: The Case of the Mortgage Market, 65 J. Fin. 333 (2010).

[97] See Susan Harrigan, Wachovia has other bankers taking notice, Wall Street Journal, April 27, 1981; Richard Phalon, A mortgage plan to help the young, New York Times, May 26, 1977.

consumption over their lifetimes, better matching housing consumption to lifetime income.[98]

This general rationale applies even in non-inflationary environments such as that which existed from 1990-2005. This was a period of declining inflation but rapid increases in both house prices and real income. On the consumption-smoothing rationale, during this period, households with expectations of higher future income should have been especially attracted to mortgages with low present and higher future payment structures. Such payment structures give borrowers the benefits of increased liquidity at the cost of increasing default risk, and may be especially attractive to sophisticated borrowers who are less averse to default. Somewhat non-intuitively, they may also be optimal for lenders, as – when coupled with prepayment penalties or prohibitions – they decrease the risk to lenders in low interest rate, or bad economy states of the world. Moreover, as a theoretical matter, the optimal alternative mortgage gives especially low, "teaser" rates to the borrowers who are least creditworthy, highest debt borrowers. [99] On theoretical grounds, therefore, one would expect to see mutually beneficial complex alternative mortgages, typically with negative amortization, being sold to both sophisticated and high-risk borrowers. This is precisely what the evidence shows. The option ARM played a central role in the California housing market, not after 2000, but during the 1990's. By 1996, one third of all mortgages being written in California were option ARM's, and for Golden West, the lender specializing in option ARM's, the average mortgage was for less than $400,000.[100] During the 2000's, with rapid housing price appreciation, option ARM's were especially important in markets with increasing income and increasing house prices.[101]

C. The Rejected Regulatory Alternative and the Illusory Online Nirvana

Long before there was a field of economic research called behavioral economics, there was the business of marketing research. For at least a half-century, that business has used a variety of techniques to attempt to more effectively communicate advertising and marketing messages to consumers. For almost as long, there has been concern that consumers do not understand the disclosures required by federal laws such as the Truth in Lending Act.[102] There is accumulating evidence that the disclosures have failed not because consumers are cognitively limited or have bizarre preferences, but because regulators have failed to attend to some old and well-established principles from consumer psychology about how to communicate to consumers.[103] To anyone who has

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98 For evidence of this effect, see Gerardi, Rosen and Willen, supra note __.

99 See Tomasz Piskorski and Alexei Tchistyi, Optimal Mortgage Design, 23 Rev. Fin. Stud. 3098 (2010); Tomasz Piskorski and Alexei Tchistyi, Stochastic House Appreciation and Optimal Mortgage Lending (Oct. 2008).

100 Foote et al. supra note __ at 9.

101 See Amromin et al, Complex Mortgages, supra note __, and João F. Cocco, Understanding the Tradeoffs of Alternative Mortgage Products (Feb. 2010).

102 See, e.g., George S. Day, Assessing the Effects of Information Disclosure Requirements, 40 J. Market. 42 (1976).

103 See Janis K. Pappalardo, Product Literacy and the Economics of Consumer Protection Policy, 46 J. Consum. Affairs 319 (2012).

recently taken out a mortgage, this is hardly a surprise. The disclosures required by the federal Truth in Lending Act, for example, are so complex and forbiddingly technical that they seem intentionally designed to confuse rather than to inform. Controlled experiments done by researchers at the Federal Trade Commission have looked at whether consumers could better identify key mortgage terms when better disclosure forms were used. These researchers used improved or prototype disclosures that were designed in light of ”a general financial analysis of the key costs of a mortgage, the types of consumer problems observed in FTC cases involving the deceptive marketing of mortgage loans, principles of effective communication, and insights gains from consumer interviews.”[104] The researchers found vast improvements in consumer understanding when the improved disclosures were used: for example, use of the improved disclosure produced a 66 per cent increase in the proportion of consumers who correctly identified the total up-front charges in the mortgage loan and a 43 per cent increase in the percentage recognizing that the loan had an additional charge for credit insurance.

Such findings suggest that the failure of some (but not all) consumers to understand mortgage terms reflects not the manipulations of profit-maximizing mortgage lenders or brokers, but the failure of regulators to design effective mortgage disclosures. To the extent that the Dodd Frank reforms improve regulatory incentives to design effective disclosures, the law would be justified. But there seems to be relatively little in the law that is directed toward such improved regulatory incentives. Indeed, the self-funding mechanism that Dodd Frank provides to the CFPB seems likely to weaken incentives for regulatory improvement.

[104] James M. Lacko and Janis K. Pappalardo, The Failure and Promise of Mandated Consumer Mortgage Disclosures: Evidence from Qualitative Interviews and a Controlled Experiment with Mortgage Borrowers, 100 Amer. Econ. Rev. 516, 518 (2010).