

## Ability to Pay

© John Pottow 2011. Do not cite or even think deeply about with author permission.

The landmark Dodd-Frank Act of 2010 transforms the landscape of consumer credit in the United States.<sup>1</sup> Many of the changes have been high-profile and accordingly attracted considerable media and scholarly attention, most notably the establishment of the Consumer Financial Protection Agency/Bureau.<sup>2</sup> Even specific consumer reforms, such as the “plain vanilla” proposal, drew hot debate and lobbying firepower.<sup>3</sup> But when the dust settled, one profoundly transformative innovation that did not garner the same outrage as plain vanilla and CFPA did get into the law: imposing upon lenders a duty to assure borrowers’ ability to repay.<sup>4</sup> Ensuring a borrower’s ability to repay is not an unprecedented legal concept, to be sure, but its wholesale embrace by Dodd-Frank represents a sea change in U.S. consumer credit market regulation. This article does three things regarding this new duty to assess ability to pay. First, it tracks the multifaceted pedigree of this rule, looking at fledgling strands in U.S. consumer law as well as other arenas such as securities law; it compares too its more robust embrace in foreign systems. Second, it offers conjecture regarding just how this broadly stated principle might be put into practice by the federal regulators. Finally, it provides a brief normative comment, siding with the supporters of this new obligation on lenders.

---

<sup>1</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No.111-203 (2010), 124 Stat. 1376 (hereinafter “Dodd-Frank”).

<sup>2</sup> See, e.g., Jim Puzzanghera, *Downgrade of Consumer Financial Protection Agency Threatens Obama's Overhaul plan*, L.A. TIMES (March 4, 2010), available at <http://articles.latimes.com/2010/mar/04/business/la-fi-financial-reform4-2010mar04>; The Hon. Jeb Hensarling, *Punishing Consumers to “Protect” Them*, THE WASHINGTON TIMES (July 22, 2009), available at [http://www.washingtontimes.com/news/2009/jul/22/dont-punish-consumers-in-the-name-of-protection/?feat=home\\_headlines](http://www.washingtontimes.com/news/2009/jul/22/dont-punish-consumers-in-the-name-of-protection/?feat=home_headlines); Tom Petruno, *Debate Heats up over “Financial Protection Agency” Proposal* (L.A. TIMES, online ed., July 23, 2009), available at [http://latimesblogs.latimes.com/money\\_co/2009/07/harvard-law-professor-elizabeth-warren-and-rep-jeb-hensarling-r-texas-are-in-a-new-smackdown-this-week-over-the-idea-of.html](http://latimesblogs.latimes.com/money_co/2009/07/harvard-law-professor-elizabeth-warren-and-rep-jeb-hensarling-r-texas-are-in-a-new-smackdown-this-week-over-the-idea-of.html); Paul Krugman, *Financial Reform Endgame*, N.Y. TIMES (Feb. 28, 2010), available at <http://www.nytimes.com/2010/03/01/opinion/01krugman.html>. Note that one compromise was the commutation of the “Agency” into a “Bureau” of the Federal Reserve Board, a largely atmospheric change given the as-enacted Bureau’s independent budgetary powers, director, etc. See Dodd-Frank at §§ 1011-1012, 124 Stat. 1964-66, § 1017, 124 Stat. 1975-79.

<sup>3</sup> See Associated Press, *Congress Wary of “Plain Vanilla” Bank Proposal Industry Thinks President Obama's Proposal Would Be Too Intrusive* (Sept. 22, 2009), available at [http://www.msnbc.msn.com/id/32968985/ns/business-consumer\\_news/](http://www.msnbc.msn.com/id/32968985/ns/business-consumer_news/); Richard H. Thaler, *Economic View: Mortgages Made Simpler* (N.Y. TIMES, online ed., July 4, 2009), available at <http://www.nytimes.com/2009/07/05/business/economy/05view.html>. Plain vanilla rules (offering safe harbor to financial product providers who offer exotic products in conjunction with simplified ones) find origination in Michael S. Barr, Sendhil Mullainathan and Eldar Shafir, *Behaviorally Informed Financial Services Regulation*, New America Foundation (2008), available at [http://www.newamerica.net/files/naf\\_behavioral\\_v5.pdf](http://www.newamerica.net/files/naf_behavioral_v5.pdf).

<sup>4</sup> Dodd-Frank at § 1411, 124 Stat. 2142.

I. **Description: What Is It and Where Did It Come From?**

**A. Ability to Pay: The Statutory Requirements**

As enacted, Dodd-Frank section 1411(b) amends TILA chapter 2 (15 USC 1631 et seq.) by inserting a new section 129C. Title XIV of Dodd-Frank is subtitled the “Mortgage Reform and Anti-predatory Lending Act,” and section 1411 provides the following new obligation on all mortgage lenders (originators and brokers):

MINIMUM STANDARDS FOR RESIDENTIAL MORTGAGE LOANS.

(a) Ability to Repay.-

(1) In general.—In accordance with regulations prescribed by the Board, no creditor may make a residential mortgage loan unless the creditor makes a reasonable and good faith determination based on verified and documented information that, at the time the loan is consummated, the consumer has a reasonable ability to repay the loan, according to its terms, and all applicable taxes, insurance (including mortgage guarantee insurance), and assessments.<sup>5</sup>

In fleshing out the discharge of this duty, Dodd-Frank continues:

(3)Basis for determination. – A determination under this subsection of a consumer’s ability to repay a residential mortgage loan shall include consideration of the consumer’s credit history, current income, expected income the consumer is reasonably 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 . . . . A creditor shall determine the ability of the consumer to repay using a payment schedule that fully amortizes the loan over the term of the loan.<sup>6</sup>

Similar requirements of assuming repayment ability are found in the cognate-spirited Credit CARD Act, with near-identical terminology.<sup>7</sup> (CARD preceded Dodd-Frank in passage, but its content is part of omnibus reform of the financial markets.)

---

<sup>5</sup> *Id.*

<sup>6</sup> *Id.*, at 2143

<sup>7</sup> Credit Card Accountability Responsibility and Disclosure Act of 2009, Pub. L. No. 111-24 (2009), § 109, 124 Stat. 1743, (“A card issuer may not open any credit card account for any consumer under an open end consumer credit plan, or increase any credit limit applicable to such account, unless the card issuer considers the ability of the

## **B. Past as Prologue: Pre-Dodd-Frank Mortgage Regulations**

Those versed in contract law doubtless appreciate the departure from *caveat emptor* the imposition that these revisions impose. Contract Law 101 insists that you are not your brother's keeper.<sup>8</sup> No more under Dodd-Frank. This thus represents a huge change to commercial law. Yet in truth the seeds of change were cross-metaphorically percolating well before 2010. Consider the recent history of residential mortgage regulation. Prior to 1982, there were good, old-fashioned rules (not standards) imposed by statute on mortgage originators, such as, for example, the hard cap of a 90% loan-to-value (LTV) ratio for improved real estate loans and maximum thirty-year full amortization terms for residential mortgages.<sup>9</sup> Then the headiness of 1980s deregulation brought such developments as the Garn-St. Germain Act<sup>10</sup> (and the related Alternative Mortgage Transactions Parity Act),<sup>11</sup> which boldly dispatched such backward-thinking, heavy-government suffocation of consumer credit. Recall that the Community Reinvestment Act was passed in 1977,<sup>12</sup> and so such deregulatory moves were not only consonant with the spirit of the 1980s but could be couched in the credit-opening rhetoric of bringing homeownership to historically underserved communities.<sup>13</sup> With traditional mortgage lenders liberated from their "stodgy" underwriting standards, housing would come to everyone at last!<sup>14</sup>

---

consumer to make the required payments under the terms of such account.”).

<sup>8</sup> See, e.g., *Laidlaw v. Organ*, 15 U.S. 178 (1817):

The maxim of *caveat emptor* could never have crept into the law, if the province of ethics had been co-extensive with it. There was, in the present case, no circumvention or manoeuvre practised by the vendee, unless rising earlier in the morning, and obtaining by superior diligence and alertness that intelligence by which the price of commodities was regulated, be such. It is a romantic equality that is contended for on the other side. Parties never can be precisely equal in knowledge, either of facts or of the inferences from such facts, and both must concur in order to satisfy the rule contended for. The absence of all authority in England and the United States, both great commercial countries, speaks volumes against the reasonableness and practicability of such a rule.

<sup>9</sup> Housing and Community Development Act of 1974, 12 U.S.C. 371, §24(a)(1) (1974) (repealed).

<sup>10</sup> Garn–St Germain Depository Institutions Act of 1982, Pub. L. No. 97-320 (1982).

<sup>11</sup> Title VIII of the Garn–St Germain Depository Institutions Act of 1982, Pub.L. No. 97–320, 96 Stat. 1469, 1545 (1982), codified at 12 U.S.C.A. § 3801 *et seq.*

<sup>12</sup> Community Reinvestment Act of 1977, Pub. L. No. 95-128 (1977), Title VIII of the Housing and Community Development Act of 1977, 91 Stat. 1147.

<sup>13</sup> Of course, an even more cynical account would be one of trying to save the thrifts during a high-inflation period by facilitating “product innovation,” such as adjustable rate mortgages. In retrospect, encouraging thrift risk-taking may not been such a great idea. See *FDIC, The S&L Crisis: A Chrono-Bibliography*, available at <http://www.fdic.gov/bank/historical/s&l/>.

<sup>14</sup> I use “stodgy” particularly here because it was the nimble talking-point characterization of regulatory consequence by the ABA’s Vice-President of outreach at a recent speech. [cite: confirm she wasn’t intending to

Post Garn-St. Germain, regulators basked in their newfound freedom. One could have predicted history unfolding two ways at this inflection point: (1) regulators might have taken over to “fill the void” and promulgate an all-encompassing swath of regulation to discipline (or, depending on one’s priors, suffocate) the mortgage market after the removal of LTV caps, or (2) regulators might have “gotten the message” and take a hand-off, light-touch approach, loath to impose financial caps that could be seen as re-treads of the discredited LTV limits from pre-1982. They got the message. The OCC, for example, considered using its rulemaking power over national banks to craft new underwriting restrictions on mortgages (along the lines of, *e.g.*, a new LTV cap), but politely declined: “Decisions concerning the forms and terms of national bank lending are properly the responsibility of each bank’s directorate and management.”<sup>15</sup> One by one, regulations were systematically eliminated over what banks were required to do with their real estate loans.<sup>16</sup> The last to fall – proscriptions on loans with an LTV ratio greater than 100% and those with longer than forty-year amortization terms – were finally repealed in 1996.<sup>17</sup> In less than two decades, mortgage lenders had gone from facing hard LTV caps to facing discipline by the market alone, with all its attendant foibles.<sup>18</sup>

There was some attempted backlash. In 1991, Congress jumped in and required regulators to adopt uniform standards for real estate lending in the FDIC Improvement Act.<sup>19</sup>

---

**talk off-record; don’t think so.]** Linguistic gymnastics abound. One man’s stodgy is another’s prudential, just as one man’s ability to pay enforcement is another’s discrimination.

<sup>15</sup> Real Estate Lending by National Banks, 48 Fed. Reg. 40699 (Sept. 9, 1983).

<sup>16</sup> An excellent summary of the regulatory history during this period is found in a current Working Paper by Vincent DiLorenzo, *The Federal Financial Consumer Protection Agency: A New Era of Protection or Mode [sic? More?] of the Same?*, St. John Legal Studies Research Paper No. 10-0182 (2010), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1674016&http://www.google.com/url?sa=t&source=web&cd=1&ved=0CBcQFjAA&url=http%3A%2F%2Fpapers.ssrn.com%2Fsol3%2FDelivery.cfm%2FSSRN\\_ID1674016\\_code436781.pdf%3Fabstractid%3D1674016%26mirid%3D1&rct=j&q=The%20Federal%20Financial%20Consumer%20Protection%20Agency%3A%20A%20New%20Era%20of%20Protection%20or%20Mode%20of%20the%20Same%3F&ei=jgBPTcnMAsLjgQev2pTjDw&usg=AFQjCNGB8QXIsulWnsTh8N\\_Euy6Vrh9h\\_A&sig2=bCP9aJmPF8HJcuGNfHPiOg](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1674016&http://www.google.com/url?sa=t&source=web&cd=1&ved=0CBcQFjAA&url=http%3A%2F%2Fpapers.ssrn.com%2Fsol3%2FDelivery.cfm%2FSSRN_ID1674016_code436781.pdf%3Fabstractid%3D1674016%26mirid%3D1&rct=j&q=The%20Federal%20Financial%20Consumer%20Protection%20Agency%3A%20A%20New%20Era%20of%20Protection%20or%20Mode%20of%20the%20Same%3F&ei=jgBPTcnMAsLjgQev2pTjDw&usg=AFQjCNGB8QXIsulWnsTh8N_Euy6Vrh9h_A&sig2=bCP9aJmPF8HJcuGNfHPiOg).

<sup>17</sup> *See id.* at 12.

<sup>18</sup> The paradigmatic “20% downpayment” was thus the result of government regulation, not a social thrift ethic.

<sup>19</sup> Federal Deposit Insurance Corporation Improvement Act of 1991, §304 Pub. L. No. 102-242, 105 Stat. 2354 (1991). In the notice of final rulemaking for the uniform standards, the federal banking agencies rationalized:

The legislative history of section 304 indicates that Congress wanted to curtail abusive real estate lending practices in order to reduce risk to the deposit insurance funds and enhance the safety and soundness of insured depository institutions. Congress considered placing explicit real estate lending restrictions in the form of loan-to-value (LTV) ratio limitations directly into the statute. Earlier versions of the legislation included specific LTV limits. Ultimately, however, Section 304 was enacted without LTV limits, or any other specific lending standards. Instead, Congress mandated that the federal banking agencies adopt uniform regulations establishing real estate lending standards without specifying what these standards should entail.

Real Estate Lending Standards, 57 Fed. Reg 62,890 (December 31, 1992) ( 12 C.F.R. 34).

This finally prompted the OCC to issue its “Real Estate Lending Standards.”<sup>20</sup> But again, a light-touch approach prevailed; the OCC eschewed rules in favor of “guidelines” that included general admonitions toward “prudential underwriting standards.”<sup>21</sup> OTC followed suit.<sup>22</sup> Even with these interventions, however, the policy impetus was with “safety and soundness” – the underlying mandate for depository institution regulation – not with any duty to the borrower as the beneficiary of some form of protective relationship.<sup>23</sup> Thus even when goaded by Congress into action, the agencies remained deep in the thrall of free-market laissez faire that was the legacy of Garn-St. Germain. How strong was their resistance-to-regulate urge (and how ill-conceived in 20/20 hindsight)? Consider the aforementioned *Real Estate Lending Standards*. They specifically excluded – as of course unrelated to the safety and soundness of the underlying depository institution – all loans that were “sold promptly after origination.”<sup>24</sup> (After all, what greater assurance to the safety and soundness of a bank than getting a loan off its books through prompt securitization? Who cares about those loans – what possible impact could they have?)<sup>25</sup>

Concomitant to this robust resurgence in *caveat emptor* starting in the 1980s was a rise in abusive mortgage practices (*e.g.*, the era of redlining). This run-up in unscrupulous lending culminated in yet another congressional intervention: the Home Ownership Equity Protection Act (HOEPA) of 1994.<sup>26</sup> HOEPA brought the Fed into the picture to pass regulations. HOEPA is not the most user-friendly of statutes, but its basic animus is to allow the Fed to regulate high-cost (*i.e.*, subprime) mortgage loans. Thus its regulatory panoply chiefly descends only upon loans that trip a high-cost trigger. For example, it covers refinancing loans (but not PMSIs) where the rate exceeds 10% above the like-duration U.S. treasuries rate.<sup>27</sup> HOEPA is of particular interest to Dodd-Frank because one of the duties it imposes upon lenders whose loans trigger its scrutiny is analysis of an “ability to repay” – but only, as interpreted, for lenders who are shown to have engaged in a “pattern or practice” of asset-based lending, *i.e.*,

---

<sup>20</sup> *Supra* note 19 at 57 Fed. Reg. 62,890.

<sup>21</sup> *Id.* at 62,889

<sup>22</sup> Office of Thrift Supervision, 61 Fed. Reg. 50951, 50978 (Sept. 30, 1996) (12 C.F.R. 545, 556, 560, 563, 566, 571, 590). Real estate lending standard in 12 C.F.R. § 560.100 and 101.

<sup>23</sup> Home Owner’s Loan Act, 48 Stat. 128, 12 U.S.C. 1461 (2001)

<sup>24</sup> *Supra* note 19 at 62,896, 62,900.

<sup>25</sup> Compare Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203 (2010) §1413(k)(1) (augmenting assignee liability), 124 Stat. 2141 (**check cite**).

<sup>26</sup> Home Ownership and Equity Protection Act (1994), 15 U.S.C. § 1639 (amending the Truth in Lending Act (TILA), 15 U.S.C. §§ 1601-1649, by adding Section 129 to TILA).

<sup>27</sup> Regulation Z, 12 CFR Part 226 (2010) (amended by Riegle Community Development and Regulatory Improvement Act of 1994, PL 103-325, 108 Stat. 2160 (60 Fed. Reg. 15463) implementing HOEPA (75 Fed. Reg. 46,837 (Aug. 4, 2010) (to be codified at 12 C.F.R. pt. 226)) (“The Home Ownership and Equity Protection Act of 1994 (HOEPA) sets forth rules for home-secured loans in which the total points and fees payable by the consumer at or before loan consummation exceed the greater of \$400 or 8 percent of the total loan amount. In keeping with the statute, the Board has annually adjusted the \$400 amount based on the annual percentage change reflected in the Consumer Price Index as reported on June 1. The adjusted dollar amount for 2011 is \$592.”).

originating loans based on (at best) collateral appraisals alone or (at worst) the incentive to generate fees.<sup>28</sup>

HOEPA thus had some kick, but it was of limited effect. The Fed was only given jurisdiction over lenders whose products triggered the high-cost loan threshold;<sup>29</sup> the OCC and OTS continued to oversee their own depository institutions. Each did pass its own set of regulations in 1996, but the regulatory thrust was perhaps not as expected. For example, OCC's big regulatory move was to confirm the permissibility of ARMs – and announce federal pre-emption of that decision over contrary ARM-banning state laws.<sup>30</sup> OTS in turn downgraded many of its own regulations to “guideline” status, explaining almost apologetically regarding the new guidelines to those by whom it was well captured: “OTS will continue to emphasize to examiners that guidance documents should not be confused with regulations.”<sup>31</sup> Thus while there were some regulatory stirrings, doubtless prompted in part by HOEPA, mortgage abuse continued relatively unabated during the 1990s.

By the turn of the millennium, however, the federal regulators took more active notice. In June 2000, the Treasury Department/HUD issued a joint report on “Curbing Predatory Home Mortgage Lending,” documenting the inadequate and gap-filled coverage of TILA, HOEPA, and RESPA as statutory interventions for this abusive mortgage lending.<sup>32</sup> The joint report recommended reforms, including, quite specifically, relaxing/repealing the restriction on HOEPA's asset-based lending ban to only “pattern or practice” lenders (in other words, expanding the imposition of a duty to analyze borrower's ability to repay).<sup>33</sup> Furthermore, the OCC and OTS finally joined the Fed and the National Credit Union Administration to promulgate a set of “Interagency Guidelines on Subprime Lending.”<sup>34</sup> (One suspects the pressure applied

---

<sup>28</sup> 75 Fed. Reg. 46,837.

<sup>29</sup>The scope of HOEPA was tinkered with over the years, but the big chance came in 2008, contemporaneous with the negotiation of Dodd-Frank, in which the Fed extended HOEPA's reach to all mortgage originators under a new national legal standard. See 73 Fed. Reg. 44,526.

<sup>30</sup> Office of the Comptroller of the Currency, 61 Fed. Reg. 11,294 (March 20, 1996) (final rule), available at <http://www.gpo.gov/fdsys/pkg/FR-1996-03-20/pdf/96-6481.pdf>.

<sup>31</sup> Office of Thrift Supervision, 61 Fed. Reg. 1162, 1163-1164 (Jan. 17, 1996) (proposed rulemaking). Available at <http://www.gpo.gov/fdsys/pkg/FR-1996-01-17/pdf/96-409.pdf>. The final rule is at 61 Fed. Reg. 50951 (Sept. 30, 1996) Available at, <http://www.gpo.gov/fdsys/pkg/FR-1996-09-30/pdf/96-23726.pdf>.

<sup>32</sup> HUD-Treasury Task Force on Predatory Lending, *Curbing Predatory Home Mortgage Lending* (2000), available at <http://www.huduser.org/publications/pdf/treasrpt.pdf>.

<sup>33</sup> *Id.* at 77-78. The Joint Report had numerous other recommendations, including working within the HOEPA framework by changing its trigger threshold. See *id.* at 86-88.

<sup>34</sup> Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. 58609 (Oct. 4, 2006) (final guidance), available at <http://www.federalreserve.gov/boarddocs/srletters/2006/SR0615a1.pdf>. Note these guidelines were passed on an effective interim basis; the final version of the guidelines did not pass until 2007. See Interagency Guidance on Nontraditional Mortgage Products, 70 Fed. Reg. 77249, 77252 (Dec. 29, 2005) (proposed guidance), available at <http://www.occ.treas.gov/news-issuances/federal-register/70fr77249.pdf>.

by state regulators who led the charge, such as North Carolina, had made continued under-activity at the federal level implausible.)<sup>35</sup> In these new *Subprime Lending Guidelines*, the regulators begrudgingly admitted that much mortgage lending in the subprime market was abusive – although they still insisted it was a problem only to the extent it imperiled the safety and soundness of regulated depository institutions.<sup>36</sup>

Significantly, roughly contemporaneous with the drafting of the *Subprime Lending Guidelines*, the OCC and OTS in 2003 for the first time embraced imposing a duty on lenders – at least in the subprime market – to analyze borrower’s “ability to repay” mortgages. The OCC’s “Guidelines for National Banks to Guard Against Predatory and Abusive Lending Practices”<sup>37</sup> and “Avoiding Predatory and Abusive Lending Practices in Borrowed and Purchased Loans,”<sup>38</sup> both cautioned banks against – but did not prohibit them from – issuing or buying mortgages made without analyzing the borrower’s ability to pay. A year later, these cautions ripened into regulations that explicitly prohibited mortgages issued without the lender considering the borrower’s ability to pay.<sup>39</sup>

The scope of these anti-predatory mortgage rules, however, was limited, only applying to depository institutions and their subsidiaries (not to their mortgage-originating affiliates – although they too eventually came under their reach).<sup>40</sup> Moreover, they were promulgated in

---

<sup>35</sup> See, e.g., N.C. Gen. Stat. 24-10.2(c) (1999) (“No lender may knowingly or intentionally engage in the unfair act or practice of ‘flipping’ a consumer home loan. ‘Flipping’ a consumer loan is the making of a consumer home loan to a borrower which refinances an existing consumer home loan when the new loan does not have reasonable, tangible net benefit to the borrower considering all of the circumstances, including the terms of both the new and refinanced loans, the cost of the new loan, and the borrower’s circumstances. This provision shall apply regardless of whether the interest rate, points, fees, and charges paid or payable by the borrower in connection with the refinancing exceed those thresholds specified in G.S. 24-1.1E(a)(6).”); Georgia Fair Lending Act, H.B. 1361 (2002) (prohibiting flipping within five years a new home loan that does not provide “tangible net benefit to the borrower”), available at [http://www1.legis.ga.gov/legis/2001\\_02/sum/hb1361.htm](http://www1.legis.ga.gov/legis/2001_02/sum/hb1361.htm); California Assembly Bill No. 489 (2001) [http://www.leginfo.ca.gov/cgi-bin/postquery?bill\\_number=ab\\_489&sess=0102&house=B&author=migden](http://www.leginfo.ca.gov/cgi-bin/postquery?bill_number=ab_489&sess=0102&house=B&author=migden).

<sup>36</sup> 70 Fed. Reg. 77250 (Dec. 29, 2005) (proposed guidance) (“[O]ur concern is elevated with nontraditional products due to the lack of principal amortization and potential accumulation of negative amortization. The Agencies are also concerned that these products and practices are being offered to a wider spectrum of borrowers, including some who may not otherwise qualify for traditional fixed-rate or other adjustable-rate mortgage loans, and who may not fully understand the associated risks.”).

<sup>37</sup> Guidelines for National Banks to Guard Against Predatory and Abusive Lending Practices, OCC Advisory Letter 2003-2 (Feb 21, 2003) 7, available at <http://www.occ.gov/static/news-issuances/memos-advisory-letters/2003/advisory-letter-2003-2.pdf>.

<sup>38</sup> Avoiding Predatory and Abusive Lending Practices in Borrowed and Purchased Loans, OCC Advisory Letter 2003-3, (Feb. 21, 2003) available at <http://www.occ.gov/static/news-issuances/memos-advisory-letters/2003/advisory-letter-2003-3.pdf>.

<sup>39</sup> Banking Activities and Operations, Real Estate Lending and Appraisals, 69 Fed. Reg. 1904 (2004). <http://www.occ.gov/news-issuances/federal-register/69fr1904.pdf>

<sup>40</sup> *Id.* at 1905 (final rule applies to “national banks and their operating subsidiaries”); 71 Fed. Reg. 58610, n. 3.

conjunction with a pre-emption decision of state predatory lending laws, some of which were quite expansive in their protection of mortgage borrowers, and so the net regulatory effect was unclear (*i.e.*, the trade-off between widening the scope of federal protection but voiding state protections).<sup>41</sup> Certainly the relaxation in credit by macroeconomic policy following the early 2000's tech-bubble correction provided counter-pressure to attempts to rein in mortgage credit. Thus while the mid-2000's saw the first emergence of an "ability to pay" duty imposed on mortgage lenders through regulation, it seems to have been a half-hearted effort of considerable foot-dragging. For example, the decision to omit the clearly mortgage-dominated "affiliates" of banks and thrifts until 2006 from subprime mortgage lending regulations is difficult to explain away as regulatory caution; the more likely narrative of a reluctant regulator has been noted even by the popular press.<sup>42</sup> (Anyone skeptical of a cynical account of regulatory capture by these federal mortgage overseers should consider that Countrywide's decision to relinquish its bank charter so it could relocate its regulatory oversight to the OTS from the OCC was quite candidly explained as driven by the OTS's wisdom to interpret the *Subprime Lending Guidelines* with more "restraint.")<sup>43</sup>

Finally, in the grand tradition of belated government regulatory action to crisis, only in 2008 after the housing collapse was well afoot did the Fed amend TILA's Regulation Z to ban high-cost HOEPA-esque loans (prime mortgages plus 1.5% for first loans) made without the lender analyzing the borrower's ability to pay and verifying income and assets.<sup>44</sup> The 2008 Regulation Z amendment was significant because, even though limited to high-cost mortgages that tripped its HOEPA-like trigger, it was not restricted to specific covered entities (such as depository institutions or their affiliates). All mortgage originators fell under its scope. (Since the amendments were not to come into force until October 1, 2009, however, they of course had no appreciable impact on the housing market collapse.)

Understandably, Dodd-Frank's 2010 injunction on all mortgage originators – of all mortgages – to consider a borrower's ability to repay the loan was a watershed. Not only did it cut through the crazy-quilt of OCC, OTS, the Fed, and others by casting a uniform statutory duty on all mortgage lenders, it applied for the first time to all mortgage loans (having seen the contagion from the subprime market to the Alt-A market and beyond), irrespective of a

---

<sup>41</sup> *Id.* at 1908-11.

<sup>42</sup> Edmund L. Andrews, *Fed and Regulators Shrugged as the Subprime Crisis Spread*, N.Y. TIMES (Dec. 18, 2007), <http://www.nytimes.com/2007/12/18/business/18subprime.html>.

<sup>43</sup> Barbara A. Rehm, *Countrywide to Drop Bank Charter in Favor of OTS*, AM. BANKER, November 10, 2006, at 1.

<sup>44</sup> Truth in Lending, 73 Fed. Reg. 44522, 12 CFR 226 (July 30, 2008), available at <http://www.gpo.gov/fdsys/pkg/FR-2008-07-30/pdf/E8-16500.pdf>.

cumbersome jurisdictional trigger regarding a high-cost nature.<sup>45</sup> “Ability to pay” had been adopted whole hog.<sup>46</sup>

### **C. Suitability? Analogues Outside the Mortgage Regulation World**

Reviewing the fitful development of the ability to pay duty might suggest that it was a foreign concept to American law. That is not true. The requirement to gauge a borrower’s ability to pay is in fact similarly spirited to “suitability” requirements found in securities regulation. Broker-dealers, even when not full-fledged fiduciary investment advisers, owe their clients a duty to recommend only “suitable” investments, mindful of the client’s particular circumstances.<sup>47</sup>

This suitability burden has a long pedigree, tracing back to the 1930s. The Maloney Act of 1938 charged the SEC to register self-regulating securities agencies, such as the NASD, in order “to prevent fraudulent and manipulative acts and practices.”<sup>48</sup> NASD Rule 2310, passed in 1939, in turn imposes a duty regarding non-institutional clients to obtain information on the customer’s financial status, tax status, investment objectives, and “such other information used or considered to be reasonable by a [broker-dealer] in making recommendations to a customer.”<sup>49</sup> (Thus were born the check-boxes we enjoy when opening a brokerage account.) Other kindred entities followed suit; the NYSE’s Rule 405, while not explicitly cast as a suitability rule, is referred to as the “Know Thy Customer Rule,” and has been interpreted to require a suitability analysis.<sup>50</sup>

---

<sup>45</sup> Note the jurisdictional trigger survives today embedded within Dodd-Frank’s definition of “qualified mortgages.” See Dodd-Frank at 2145-50, discussed in Part II, *infra*.

<sup>46</sup> The all-encompassing reach of Dodd-Frank renders the continued relevance of HOEPA’s triggers unclear. That is, if only high-cost loans fall under HOEPA’s purview, but all loans are now subject to the Dodd-Frank ability to pay duty, then at least that aspect of HOEPA is redundant. Bizarrely, Dodd-Frank itself amended parts of HOEPA’s (seemingly redundant) high-cost loan definitional triggers. At a recent conference on consumer enforcement under Dodd-Frank, I asked a regulator about this (off-record) and was met with the worldly response that yes, Dodd-Frank did reveal some legislative inelegance and redundancy.

<sup>47</sup> Frank A. Hirsch, *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, 21-24 (2008) (“Suitability is a concept recognized in the securities law that imposes a duty on a securities broker to sell only securities to a buyer that are ‘suitable’ for the buyer based on the buyer’s financial wherewithal, tax status, investment objectives and other factors.”). **[cite: add explanation of broker-dealer vs. investment adviser.]**

<sup>48</sup> Maloney Act, Pub. L. 75–719, 52 Stat. 1070 (1938) (codified as amended at 15 U.S.C. 78o, authorizing the U.S. Securities and Exchange Commission to register national securities associations).

<sup>49</sup> NASD Conduct Rule 2310 (formerly Article III, Section 2 of the NASD Rules of Fair Practice).

<sup>50</sup> Financial Industry Regulatory Authority (Finra), Regulatory Notice 09-25, *Suitability and “Know Your Customer” Proposed Consolidated FINRA Rules Governing Suitability and Know-Your-Customer Obligations*, (May 2009), at n. 5, available at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p118709.pdf>.

The SEC itself has not explicitly passed a suitability rule, although its practices have been to read one into its general anti-fraud proscription and its broad injunction of “fair dealing.”<sup>51</sup> Relatedly, the SEC has, with a few exceptions, eschewed direct ex ante regulation in favor of case-by-case adjudication that delineates this suitability standard incrementally.<sup>52</sup> (Those few exceptions included the SECO Rule for Non-NASD brokers that governed before mandatory registration was passed in 1983 – it required “reasonable grounds to believe ... [a] recommendation is not unsuitable for such customer”<sup>53</sup> – as well as Rule 15c2-5 on margin trading.<sup>54</sup> The SEC does have what might be considered “indirect” ex ante suitability regulations, such as the categorical exclusionary effects of the accredited investor rules of Regulation D,<sup>55</sup> and more specifically Rule 15g-9’s restrictions on trading in penny stocks,<sup>56</sup> but for the most part has declined promulgating direct ex ante rules squarely on topic.) Moreover, the case-by-case adjudication of suitability does not even occur at the SEC; it actually occurs primarily through NASD self-discipline (*i.e.*, FINRA arbitrations),<sup>57</sup> albeit with occasional SEC direct enforcement against wayward broker-dealers.<sup>58</sup> (A private right of action is also implied under the securities law but has not been known to generate landmark awards).<sup>59</sup>

Accordingly, although the SEC’s suitability standard has not been elaborated through regulation, it has developed over time with a rich interpretative history. Not only has that history shown the content of the standard but also its deep-seated paternalism. Consider, for example, that it has been determined to be no defense to a suitability violation to plead

---

<sup>51</sup> SEC, *Guide to Broker-Dealer Registration* (2008), available at <http://www.sec.gov/divisions/marketreg/bdguide.htm>.

<sup>52</sup> (Cite to secondary source E.g., Engel & McCoy mention it in passing.)

<sup>53</sup> 17 CFR 240.15b10-3.

<sup>54</sup> 17 CFR 240.15c2-5.

<sup>55</sup> 17 CFR § 230.501, § 230.505-506.

<sup>56</sup> 17 CFR 240.15g-9, <http://www.sec.gov/rules/final/34-51983.pdf>.

<sup>57</sup> FINRA, *Arbitration & Mediation Rules*, available at <http://www.finra.org/ArbitrationMediation/Rules>.

<sup>58</sup> See 15 U.S.C. § 78j(b) [or 1934 SEC Act § 10(b)5]; see also, *e.g.*, SEC v. Ainsworth, No. EDCV 08-1350 (C.D. Cal. Sept. 29, 2008) (SEC filed suit against a group of securities brokers in California, alleging they sold unsuitable securities to customers with little formal education, did not speak English fluently, and lacked funds necessary to purchase the securities recommended by defendants absent refinancing), available at <http://www.sec.gov/litigation/complaints/2008/comp20768.pdf>.

<sup>59</sup> See Jonathan R. Macey, Geoffrey P. Miller, Maureen O'Hara & Gabriel D. Rosenberg, *Helping Law Catch Up To Markets: Applying Broker-Dealer Law To Subprime Mortgage*, 34 J. CORP. L. 789, 817 (2009) (“SEC and federal courts have found broker-dealers personally liable for suitability violations under section 10(b) of the Securities Exchange Act and SEC Rule 10b-5, under which private rights of action are implied.”); Kathleen Engel and Patricia McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L.R. 1255, 1316, 1338-39 (2002) (describing how “low and uncertain damage awards” reduce the number of suitability cases and that punitive damage awards are capped at \$11,000 under FHA limits).

disclosure; unsuitable investment recommendations are categorically prohibited, regardless of what the broker tells the client.<sup>60</sup> This paternalism reveals that while suitability is most avowedly not a fiduciary duty, it is, like a duty to analyze ability to repay, a strong abrogation of *caveat emptor*.

Given this lengthy history of usage in the securities arena, it is perhaps not surprising this quasi-fiduciary concept of suitability was on the minds of many leading up to the passage of Dodd-Frank. Indeed, one of Dodd-Frank's precursors, the would-be Borrower's Protection Act of 2007, went so far as to propose that "[i]n the case of a home mortgage loan, the mortgage brokers shall have a fiduciary relationship with the consumer, and each such mortgage broker shall be subject to all requirements for fiduciaries otherwise applicable under State or Federal law."<sup>61</sup> The Mortgage Reform and Anti-Predatory Lending Act of 2007 (that mostly found its way into Title XIV of Dodd-Frank) ended up taking a more modest approach, avoiding the contentious concept of suitability and instead suggesting tweaks to the "high-cost loan" trigger for HOEPA in order to expand its regulatory reach over problematic mortgages.<sup>62</sup> Expressly bowing to the charged nature of suitability and not wanting a fight, sponsor Rep. Frank assured, "We felt a suitability standard was too vague. . . . We don't want to give people an obligation that is too vague and obscure because you can scare people away from doing anything. We think these [proposals] are less subjective than suitability."<sup>63</sup>

Similarly, the Final Guidance on Subprime Mortgage Lending from 2007 (implementing the *Subprime Lending Guidelines*, discussed above) made clear that while the participating agencies were passing specific regulations proscribing certain lending practices,<sup>64</sup> they were most unequivocally not going to embrace suitability:

The Agencies disagree with the commentators who expressed concern that the proposed statement appears to establish a suitability standard under which lenders would be required to assist borrowers in choosing products that are appropriate to their needs and circumstances.

---

<sup>60</sup> See *In re Stein*, S.E.C. Release No. 47335, 79 SEC Docket 1777 (Feb. 11, 2003), 2003 WL 431870, at 2 ("Registered representative does not satisfy the suitability requirement simply by disclosing the risk of an investment that he or she has recommended.").

<sup>61</sup> Borrower's Protection Act of 2007, S. 1299 § 2, 110th Cong. (2007).

<sup>62</sup> See Dodd-Frank, 124. Stat. 2157-60, § 1431. Note these HOEPA-altering provisions remained in the law. See also Legislative Proposals on Reforming Mortgage Practices: Hearing on H.R. 3915 Before the H. Fin. Servs. Comm., 110th Cong. (2007) (statement of Marc Savitt, President-Elect, Nat'l Ass'n of Mortgage Brokers) (discussing suitability) (**cite**), available at <http://financialservices.house.gov/hearing110/htsavitt102407.pdf>,

<sup>63</sup> Binyamin Appelbaum, *Frank's Bill Seeks Rules for Lenders*, BOSTON GLOBE, Oct. 23, 2007, at D1 (quoting Representative Barney Frank), available at [http://www.boston.com/business/personalfinance/articles/2007/10/23/franks\\_bill\\_seeks\\_rules\\_for\\_lenders/](http://www.boston.com/business/personalfinance/articles/2007/10/23/franks_bill_seeks_rules_for_lenders/).

<sup>64</sup> Statement on Subprime Mortgage Lending, 72 Fed. Reg. 37,569 (July 10, 2007), available at <http://www.gpo.gov/fdsys/pkg/FR-2007-07-10/pdf/07-3316.pdf>.

The commentators argued that lenders are not in a position to determine which products are most suitable for borrowers, and that this decision should be left to borrowers themselves. It is not the Agencies' intent to impose such a standard, nor is there any language in the Statement that does so.<sup>65</sup>

The final version of Dodd-Frank, while eschewing suitability outright, did get close. In addition to shouldering lenders with the affirmative duty to analyze ability to repay that is the subject of this article, it even sought to propose a specific "net tangible benefit" test for refinancing loans.<sup>66</sup> While that was left on the cutting room floor to ensure passage, the surviving ability to pay requirement captures most if not all of the content of that rule.<sup>67</sup>

Thus it was not just the regulatory trial balloons in the 1990s and beyond in the mortgage oversight realm that gave rise to the Dodd-Frank ability to repay analysis duty, it was also a parallel rich history in the securities field that played a role too.<sup>68</sup> (It was also not just the securities field; insurance regulation has also seen suitability codified through the Gramm-Leach-Bliley Act of 1999, which requires insurance products to be "suitable and appropriate for the consumer.")<sup>69</sup>

---

<sup>65</sup> *Id.* at 37,572.

<sup>66</sup> See Mortgage Reform and Anti-Predatory Lending Act of 2007, H.R. 3915, 110th Cong. sec. 202, § 129B(b)(1)-(b)(3). ("No creditor may extend credit in connection with any residential mortgage loan that involves a refinancing of a prior existing residential mortgage loan unless the creditor reasonably and in good faith determines, at the time the loan is consummated and on the basis of information known by or obtained in good faith by the creditor, that the refinanced loan will provide a net tangible benefit to the consumer."). Available at <http://www.gpo.gov/fdsys/pkg/BILLS-110hr3915eh/pdf/BILLS-110hr3915eh.pdf>.

<sup>67</sup> Macey et al. seek to distinguish suitability from ability to pay. See Macey et al., *supra* note 59, at 832, 836-37 (borrower's ability to repay is a necessary but not sufficient condition of suitability). I actually think they overstate difference; the language is different, just as conceptually the latter is a subset of the former, but their shared normative underpinnings are strongly kindred in my view.

<sup>68</sup> Interestingly, some creative litigants have sought to advance suitability duties for mortgage brokers by extending state unfair/abusive practices laws. See, e.g., *Leff v. EquiHome Mortgage Corp.*, 2007 WL 2572362; *Tingley v. Beazer Homes Corp.* (D. N.J. Sept. 4, 2007), 2008 WL 1902108 (D. N.C. April 25, 2008).

<sup>69</sup> Gramm-Leach-Bliley Act, Pub. L. 106-102 (1999), Subtitle C, 113 Stat. 1422-24, available at <http://www.gpo.gov:80/fdsys/pkg/PLAW-106publ102/pdf/PLAW-106publ102.pdf>. The act requires a majority of states to enact reciprocal laws or uniform laws governing the licensure of individuals and entities authorized to sell and solicit insurance no later than three years after the act was enacted. States satisfy the uniformity requirement when they "establish uniform criteria to ensure that an insurance product . . . sold to a consumer is suitable and appropriate for the consumer." If after three years a majority of states failed to enact uniform or reciprocal licensing laws, then the National Association of Registered Agents and Brokers would have been established to carry out multi-state licensing, but a majority did so enact so this nationalizing threat never realized. **(cite: confirm.)**

#### **D. Foreign Cognates**

A duty to analyze repayment ability, while perhaps late-coming to the American scene, has been found in other countries' laws for some time. France, for example, has prohibited banks to advise borrowers to assume more debt than they can repay, and even has a quite specific 33% debt service cap on disposable income.<sup>70</sup> Denmark, which has been singled out for praise by the IMF for its stable mortgage market regulation, passed a 2003 Mortgage-Credit Loans and Mortgage-Credit Bonds Act, capping residential, owner-occupied mortgages at 80% LTV.<sup>71</sup> (Denmark further regulates its MBS markets by requiring matching underlying mortgage maturity dates to the term of securities issued, a practice known as the "balance principle.")<sup>72</sup>

Others too have been galvanized by the mortgage crisis. For example, the Canadians in October 2008 changed minimum standards for government-backed mortgages (mortgages with less than 20% down-payments, for which the government mandates mortgage insurance) to impose upon the lender a "reasonable effort to verify that the borrower can afford the loan payment."<sup>73</sup> (In February 2010, the permissible principal amount a homeowner can take out in refinancing such a mortgage was lowered from 95% to 90%.)<sup>74</sup> In the most populous province of Ontario, moreover, provincial regulators went even further and in 2008 adopted an express suitability standard for mortgage brokers, which requires consideration of "the needs and circumstances of the borrower," as well as the implementation of procedures and practices to ensure "the suitability of a mortgage . . . for a borrower."<sup>75</sup>

Australia too took action, passing the National Consumer Credit Protection Act of 2009, which went beyond a mere duty to analyze ability to repay to an even broader affirmative duty of "responsible lending."<sup>76</sup> Such duty includes within it an obligation to assess "whether the

---

<sup>70</sup> *The French Model: Vive la différence! The French Way of Doing Things Looks Pretty Good—at Least in These Troubled Economic Times*, THE ECONOMIST (May 7, 2009), available at <http://www.economist.com/node/13610197>.

<sup>71</sup> Mortgage-Credit Loans and Mortgage-Credit Bonds Act, unofficial English translation (2003), § 5(1), available at [http://www.finanstilsynet.dk/upload/Finanstilsynet/Mediafiles/newdoc/Acts/Act454\\_100603H.pdf](http://www.finanstilsynet.dk/upload/Finanstilsynet/Mediafiles/newdoc/Acts/Act454_100603H.pdf).

<sup>72</sup> See INTERNATIONAL MONETARY FUND, DENMARK: FINANCIAL SECTOR ASSESSMENT PROGRAM – TECHNICAL NOTE – THE DANISH MORTGAGE MARKET – A COMPARATIVE ANALYSIS 5 (2007) available at <http://www.imf.org/external/pubs/ft/scr/2007/cr07123.pdf>.

<sup>73</sup> Press Release, Annette Robertson, Press Secretary, Office of the Minister of Finance, *Government of Canada Takes Action to Strengthen Housing Financing – Background*, (Feb. 16, 2010), available at [http://www.fin.gc.ca/n10/data/10-011\\_1-eng.asp](http://www.fin.gc.ca/n10/data/10-011_1-eng.asp).

<sup>74</sup> *Id.*

<sup>75</sup> Ontario Regulation 188/08, *enacted pursuant to Mortgage Brokerages, Lenders and Administrators Act, 2006*, § 24, available at [http://www.e-aws.gov.on.ca/html/source/regs/english/2008/elaws\\_src\\_regs\\_r08188\\_e.htm#BK29](http://www.e-aws.gov.on.ca/html/source/regs/english/2008/elaws_src_regs_r08188_e.htm#BK29).

<sup>76</sup> National Consumer Credit Protection Act 2009 available at <http://www.comlaw.gov.au/Details/C2009A00134>.

credit contract will be unsuitable for the consumer if the contract is entered or the credit limit increased.”<sup>77</sup> Australia’s suitability duty expressly requires consideration of the likelihood the consumer will be unable to comply with the financial obligations of the contract or whether compliance will engender “substantial hardship” on the consumer.<sup>78</sup>

Australia’s invocation of a duty of “responsible lending” implicates a hotly contested policy debate that has been brewing in Europe for some time. There, several civil jurisdictions place fiduciary-like responsibility squarely on lenders. For example, Germany recognizes “sittenwidrige Überschuldung” (immoral overburdening with debts) in its domestic law,<sup>79</sup> and Sweden’s Consumer Credit and Banking Act bans the extension of credit to borrowers who cannot be expected to repay (allowing a private remedy of “debt adjustment” by the borrower for violation).<sup>80</sup> These strong consumer protections by way of saddling arms-length lenders with affirmative duties to consider the needs of others helped ground a movement at the European Union level to revise its Consumer Credit Directive to impose upon member states standardized policies of policing lending practices.<sup>81</sup> (This project ultimately ended up excluding mortgage products from its scope, but they in turn faced their own regulation, discussed below.)

The initial proposed EU directive, floated in 2002, had a “responsible lending” section that contained an obligation to gauge a debtor’s ability to repay.<sup>82</sup> But this concept met marked opposition from the United Kingdom, which in commentary expressed “doubts about the value of a ‘responsible lending’ provision.”<sup>83</sup> Consequently, the next draft in 2005 whittled down this duty to become one of only “advising” and “providing adequate information,”<sup>84</sup> with an explicit admonition that the borrower bears ultimate responsibility of deciding what credit is

---

<sup>77</sup> *Id.* at Chapter 3, Part 3-1, Division 4, § 116(1)(b), Chapter 3, part 3-2, Division 3, § 129(b).

<sup>78</sup> *Id.* at Chapter 3, Part 3-1, Division 4, § 118(2)(a), Chapter 3, part 3-2, Division 3, § 131(2)(a).

<sup>79</sup> See Udo Reifner et al., CONSUMER OVERINDEBTEDNESS AND CONSUMER LAW IN THE EUROPEAN UNION, 100-01 (2003)

<sup>80</sup> *Id.* at 100.

<sup>81</sup> See Directive 2008/48/EC of the European Parliament and of the Council of 23 April 2008 on credit agreements for consumers and repealing Council Directive 87/102/EEC, available at [http://eur-lex.europa.eu/Result.do?T1=V3&T2=2008&T3=48&RechType=RECH\\_naturel&Submit=Search](http://eur-lex.europa.eu/Result.do?T1=V3&T2=2008&T3=48&RechType=RECH_naturel&Submit=Search).

<sup>82</sup> See Proposal for a Directive of the European Parliament and of the Council on the harmonisation of the laws, regulations and administrative provisions of the Member States concerning credit for consumers, at 15-6, 40, COM (2002) 443 final (Sept. 11, 2002), available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2002:0443:FIN:EN:PDF>.

<sup>83</sup> DEP’T TRADE & INDUS., PROPOSAL FOR AN EC CONSUMER CREDIT DIRECTIVE—SUPPLEMENTARY CONSULTATION 5, 13 (2006), available at <http://www.dti.gov.uk/files/file27459.pdf>.

<sup>84</sup> See Modified Proposal for a Directive of the European Parliament and of the Council on Credit Agreements for Consumers Amending Council Directive 93/13/EC, at 2, 6, 31, COM (2005) 483 final (Oct. 7, 2005) (stating that it is only necessary to consult databases “where appropriate”), available at [http://ec.europa.eu/consumers/cons\\_int/fina\\_serv/cons\\_directive/2ndproposal\\_en.pdf](http://ec.europa.eu/consumers/cons_int/fina_serv/cons_directive/2ndproposal_en.pdf).

appropriate.<sup>85</sup> When the credit collapse hit, however, the UK's resistance to burdening lenders with unfair duties lost punch; the final version of the directive, as enacted in 2008, while employing vaguer language than the initial draft, unquestionably shifts most responsibility back to the lender: "Member states should take appropriate measures to promote responsible lending practices . . . ."<sup>86</sup> Expanding, the directive chides: "It is important that creditors should not engage in irresponsible lending or give out credit without prior assessment of creditworthiness . . . ."<sup>87</sup>

The EU followed up on the Consumer Credit Directive with its carved-out proposal on Responsible Mortgage Lending and Borrowing.<sup>88</sup> The first proposal is expected to be circulated in March 2011, but preliminary documents give a good idea of the tack being followed. A 2009 Public Consultation, for example, catalogues that Austria, Belgium, Hungary, Ireland, Malta, and the Netherlands already require suitability assessments of mortgage products based on the consumer's personal circumstances.<sup>89</sup> It also explores the possibility of "creditworthiness and/or suitability assessments before granting consumer and mortgage loans."<sup>90</sup> A 2010 Working Paper goes further and suggests that an ability to pay (creditworthiness assessment) be included in the upcoming directive: "[T]he creditor . . . should thoroughly assess the suitability of credit contracts for the consumer's personal and financial circumstances on the basis of sufficient information, where appropriate obtained from the consumer."<sup>91</sup> Unlike "hard" suitability under US securities law, however, the proto-proposal of the EU's 2010 Working Paper envisions an insistent consumer being able to proceed with an unsuitable credit contract after express disclosure, warning, and written waiver – waiveable ("soft") suitability, but suitability nonetheless.<sup>92</sup>

The Europeans thus have not only had suitability (and even fiduciary duties) imposed on their lenders for some time, they are clearly strengthening and expanding those duties in EU-wide responses to the economic crisis. Indeed, even previous holdout the UK has apparently had second thoughts on the efficacy of market discipline alone. In an FSA Discussion Paper of 2009 of Mortgage Market Review, an "Affordability Assessment Model" was put forward to

---

<sup>85</sup> *Id.* at 6.

<sup>86</sup> *See Directive, supra* note 81, at §26.

<sup>87</sup> *Id.*

<sup>88</sup> EUROPEAN COMMISSION, WORKING PAPER ON RESPONSIBLE MORTGAGE LENDING AND BORROWING 1 (July 2010), *available at* <http://www.fininc.eu/gallery/documents/efin-news/work-paper-resp-lending-2010-07-22.pdf>.

<sup>89</sup> EUROPEAN COMMISSION, PUBLIC CONSULTATION ON RESPONSIBLE LENDING AND BORROWING IN THE EU, 7 FN 17 (June 2009) *available at* [http://ec.europa.eu/internal\\_market/consultations/docs/2009/responsible\\_lending/consultation\\_en.pdf](http://ec.europa.eu/internal_market/consultations/docs/2009/responsible_lending/consultation_en.pdf).

<sup>90</sup> *Id.* at 6-8.

<sup>91</sup> EUROPEAN COMMISSION, WORKING PAPER ON RESPONSIBLE MORTGAGE LENDING AND BORROWING 9 (July 2010) *available at* <http://www.fininc.eu/gallery/documents/efin-news/work-paper-resp-lending-2010-07-22.pdf>.

<sup>92</sup> *Id.* at 8-9.

require lenders to assure credit be extended only to homeowners who could afford repayment.<sup>93</sup> The Model further imposes an obligation to verify affordability by calculating the borrower's "free disposable income" that is available for debt service.<sup>94</sup> FSA backed off, however, from suggestions for more rule-based limits, such as a hard LTV cap (or DTI cap) on residential mortgage loans.<sup>95</sup> FSA's Mortgage Market Review of 2010 confirmed this affordability approach and even considered stricter rules for "credit impaired" borrowers, such as a 20% "buffer" in calculating free disposable income.<sup>96</sup>

Finally, quick mention should be made in discussing other jurisdictions' approaches to mortgage market regulation to the Basel Committee on Banking Supervision. Because the mortgage meltdown had global systemic ramifications, Basel too became involved in offering recommendations for banks.<sup>97</sup> Minimum underwriting standards, including repayment capacity analysis, effective income verification, and "appropriate" LTVs, have all been included in Basel's suggestions, although with nowhere close to the specificity found in many domestic proposals.<sup>98</sup>

This brief comparative law overview shows how some countries have had ability to pay, suitability, and even full-throated responsible lending duties imposed upon mortgage credit providers for some time. It also shows a convergence of concepts and terminology. The panic-inducing collapse of global mortgage markets may well have herded countries toward a harmonizing regulatory path, where a duty to ensure ability to repay no longer seems innovative but commonplace.

### **E. Academic Support**

Finally, just as Elizabeth Warren agitated for a consumer financial protection agency for some time,<sup>99</sup> so too have academics been keeping the pressure on for some form of suitability or similar duty on mortgage lenders. Kathleen Engel and Patricia McCoy (the latter of whom is

---

<sup>93</sup> FINANCIAL SERVICES AUTHORITY, DISCUSSION PAPER 09/3 MORTGAGE MARKET REVIEW 51 (October 2009), *available at* [http://www.fsa.gov.uk/pages/Library/Policy/DP/2009/09\\_03.shtml](http://www.fsa.gov.uk/pages/Library/Policy/DP/2009/09_03.shtml).

<sup>94</sup> *Id.* at 12.

<sup>95</sup> *Id.* at 11, 37.

<sup>96</sup> FINANCIAL SERVICES AUTHORITY, CONSULTATION PAPER 10/16 MORTGAGE MARKET REVIEW 9, 28 (2010), *available at* [http://www.fsa.gov.uk/pages/Library/Policy/CP/2010/10\\_16.shtml](http://www.fsa.gov.uk/pages/Library/Policy/CP/2010/10_16.shtml).

<sup>97</sup> JOINT FORUM, REVIEW OF THE DIFFERENTIATED NATURE AND SCOPE OF FINANCIAL REGULATION – KEY ISSUES AND RECOMMENDATIONS (2010), *available at* <http://www.bis.org/publ/joint24.htm>

<sup>98</sup> *Id.* at 15-7.

<sup>99</sup> See Elizabeth Warren, *Unsafe at Any Rate*, 5 DEMOCRACY 8 (2007), *available at* [www.democracyjournal.org/pdf/5/Warren.pdf](http://www.democracyjournal.org/pdf/5/Warren.pdf).

now nominated to run one of the CFPB's branches)<sup>100</sup> win the salience award for their 2002 *Texas Law Review* article, in which they propose "a duty of suitability in subprime mortgage lending."<sup>101</sup> Making their case, Engel and McCoy "draw upon suitability in securities and insurance" to explain that the "new duty of suitability puts the onus of preventing predatory lending on those who can afford it most cheaply (i.e., predatory lenders and brokers) by authorizing the federal government and aggrieved victims to sue for loan reformation, disgorgement, and damages."<sup>102</sup> (Note that even Engel and McCoy were not so bold as to suggest blanket application of suitability to the entire mortgage market – as Dodd-Frank does – just to the subprime market; it's amazing what an intervening global economic collapse will do.) Their focus on private remedies to enforce newly placed duties on lenders mirrored other agitants' cries that warned of "reckless lending" infecting the consumer credit markets.<sup>103</sup>

Engel and McCoy were not alone. Daniel Ehrenberg also advocated suitability, borrowing more directly from securities law.<sup>104</sup> Some even made the argument that suitability could (and should) be attached under current securities law, under the theory that mortgage sales could be seen as transactions "in connection with" purchase and sale of securities.<sup>105</sup> In addition to like-minded supporters, there were also the critics, such as Todd Zywicki and Jack Guttentag, the latter of whom snorted, "Nobody makes loans known to be unaffordable at the outset except collateral lenders . . . and perpetrators of fraud."<sup>106</sup> One of the more bizarre critiques came from Anthony Yezer, who protested that a suitability standard would be tough for the average bank because loan officers would need to have committed to memory hundreds of their products to discharge this duty effectively.<sup>107</sup> (Even leaving aside the

---

<sup>100</sup> U.S. Department of the Treasury, Press Center: Treasury Department Announces Senior Hires for CFPB Implementation Team (Feb. 17 2011) (McCoy hired as Assistant Director for Mortgage and Home Equity Markets) Available at <http://www.treasury.gov/press-center/press-releases/Pages/tg1070.aspx>.

<sup>101</sup> See Engel and McCoy, *supra* note 59, at 1259.

<sup>102</sup> *Id.*

<sup>103</sup> Vern Countryman, *Improvident Credit Extension: A New Legal Concept Aborning?*, 27 ME. L. REV. 1, 17–18 (1975); see also John A. E. Pottow, *Private Liability for Reckless Lending*, 2007 U. ILL. L. REV. 1.

<sup>104</sup> 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-WTR J. AFFORDABLE HOUSING AND COMMUNITY DEV. L. 117, 125-27 (2001).

<sup>105</sup> See Macey et al., *supra* note 59, at 792, at 809, 813 (arguing, inter alia, a subprime mortgage might a "note" for securities law purpose (and not a mere "debt") under the *Reves* test because "we believe that some mortgages have crossed the line between financial vehicles used to finance personal consumption (which are not securities) and financial instruments with significant investment components that should be categorized as notes regardless of the fact that there is a consumption component involved.").

<sup>106</sup> Jack Guttentag, *Suitability Standards Could Carry Unintended Consequences*, WASH. POST (Mar. 31, 2007), available at <http://www.washingtonpost.com/wp-dyn/content/article/2007/03/30/AR2007033001016.html>; see also, e.g., Todd Zywicki and Joseph Adamson, *The Law & Economics of Subprime Lending*, 80 U. COLO. L. REV. 1, 78 (2009) available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1106907](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1106907).

<sup>107</sup> See *Ending Mortgage Abuse: Safeguarding Homebuyers: Hearing Before the Sen. Subcomm. on Hous., Transp.*

likelihood that a broker-dealer surely needs familiarity with a similar number of investment products to discharge his suitability duty, and the fact that securities law has not collapsed under the weight of such a rule, one is left wondering just how non-repeat mortgage borrowers would be better situated to memorize such offerings than their loan officers.) Finally, Richard Posner contributed his requisite chime-in, arguably signaling conclusion of the intellectual discussion.<sup>108</sup> Thus, Dodd-Frank's ability to repay duty can be seen not just as the output of gradual change working its way through the field of extant U.S. mortgage regulations (coupled with the unprecedented housing market collapse), but as the product of a convergence of intellectual pressure from domestic regulators, state legal entrepreneurs (like North Carolina), non-mortgage regulators in the securities field, foreign jurisdictions, and academic commentators.

## **II: Analysis: What Will It Actually Look Like?**

Dodd-Frank gives a set of deadlines to enact mandated regulations, usually measured from its "effective date."<sup>109</sup> Thus we know the various implicated agencies will be in overdrive.<sup>110</sup> But beyond that, we have little to go on in predicting just how this new lender duty will be interpreted. For example, in the United Kingdom, regulators expressed serious reservation about the "inflexibility" of imposing strict caps on LTV and DTI to bar certain types of loans.<sup>111</sup> On the other hand, within the domestic HOEPA framework, there is ready willingness to set very specific numerical rules, right down to the jurisdictional trigger.<sup>112</sup> How

---

*and Community Dev. of the Sen. Comm. on Banking, Hous., and Urban Affairs*, 109th Cong. 5 (2007) (written testimony by Professor Anthony M. Yezer, George Washington University), available at [http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Testimony&Hearing\\_ID=827e024e-707e-4edb-b4b5-ffa285d19982&Witness\\_ID=877fac70-cca2-42e6-bf27-0f94c336e054](http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Testimony&Hearing_ID=827e024e-707e-4edb-b4b5-ffa285d19982&Witness_ID=877fac70-cca2-42e6-bf27-0f94c336e054).

<sup>108</sup> Richard A. Posner, *Treating Financial Consumers as Consenting Adults*, WALL ST. J. (July 22, 2009), available at <http://online.wsj.com/article/SB10001424052970203946904574302213213148166.html>.

<sup>109</sup> Dodd-Frank at 2136, § 1400(c) (regulations under Title XIV become effective twelve months after the Board issues final regulations and guidelines and the Act requires the Board to issue final regulations within eighteen months after the transfer date), 75 Fed.Reg. 57252-53, (Sept. 20, 2010) (transfer date is July 21, 2011, when "consumer financial protection functions" currently carried out by the Federal banking agencies, as well as certain authorities currently carried out by the Department of Housing and Urban Development and the Federal Trade Commission, will be transferred to the CFPB"), available at <http://edocket.access.gpo.gov/2010/pdf/2010-23487.pdf>.

<sup>110</sup> Dodd-Frank at 2148, §1412(3)(ii) (HUD, Dept. of Agriculture, Dept. of Veterans Affairs and the Rural Housing Service shall in consultation with the [Federal Reserve] Board prescribe rules defining the types of loans they insure, guarantee or administer that are qualified mortgages for the purposes of the safe harbor provision). On the transfer date, "consumer financial protection functions" carried out by Federal banking agencies, HUD and FTC will be transferred to CFPB; specifically CFPB will "assume responsibility for consumer compliance supervision of very large depository institutions and their affiliates and promulgating regulations under various Federal consumer financial laws" and "take steps to implement the risk-based supervision of nondepository covered persons." 75 Fed. Reg. 57253.

<sup>111</sup> See *supra* note 95.

<sup>112</sup> See *supra* note 27; see also Dodd-Frank at 2146-47, §1412(2)(c), 124 Stat. 2157-60, §1431.

should we read between the statutory lines with Dodd-Frank? For instance, is the expansion of the duty to analyze ability to pay to all loans (rather than just high-cost ones) an implicit decision that Congress wants the reach of regulation to be as broad as possible?

The relevant commands of the statute itself are intriguing in this respect. They begin with a standard-like injunction of barring loans that are underwritten without analyzing the borrower's ability to repay.<sup>113</sup> This broad exhortation is followed by a statutory list of mandated factors to consider, which includes the "consumer's credit history, current income, expected income the consumer is reasonably 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 or real property that secures repayment of the loan."<sup>114</sup> This is a comprehensive-sounding list, to be sure, but one that actually requires no specific weighting of any of its constitutive elements. Moreover, the statutory specificity continues even down to the next level of implementation, where the duty to verify income is in turn micromanaged regarding which documents to requisition: W-2s, tax returns, payroll receipts, etc.<sup>115</sup> Countless other examples abound of this statute-level detail, such as how to account properly for an ARM or non-fully amortizing loan in working the ability to repay analysis.<sup>116</sup>

Perhaps most significantly, the statute also provides a specific presumption to interpret the ability to repay, in a section captioned, "Safe Harbor and Rebuttable Presumption." Section 1412 amends (as amended!) TILA section 129C after subsection (a) with a new subsection (b):

(b) Presumption of Ability to Repay.—

(1) In General.—Any creditor with respect to a residential mortgage loan, and any assignee of such loan subject to liability, may presume that the loan has met the requirements of subsection (a), if the loan is a qualified mortgage.

(2) Definitions.— . . .

(A) Qualified Mortgage.-- [defining the term over a page of statutory text, including in relevant part: "(vi) that complies with any guidelines or regulations established by the Board in relation to ratios of total monthly debt to monthly income, 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

---

<sup>113</sup> See Dodd-Frank, 124 Stat. at 2139, §1402, 124 Stat. 2142, §1411.

<sup>114</sup> *Id.* at 2143, §129C(a)(3).

<sup>115</sup> *Id.* at §129C(a)(4).

<sup>116</sup> *Id.* at 2144, §129C(a)(6).

determine relevant and consistent with the purposes of described in paragraph (3)(B)(i).”]<sup>117</sup>

Note that this highly detailed statutory definition is in turn followed by a broad re-definition authority conferred in the subsequent subsection:

(3) Regulations.-- . . .

(B) Revision to Safe Harbor Criteria.-- The Board may prescribe regulations that revise, add to, or subtract from the criteria that define a qualified mortgage upon a finding that such regulations are necessary or proper to ensure that responsible, affordable mortgage credit remains available to consumers in a manner consistent with the purposes of this section, necessary and appropriate to effectuate the purposes of this section and section 129B to prevent circumvention or evasion thereof, or to facilitate compliance with such sections.”<sup>118</sup>

Making sense of this interpretative presumption is difficult. At first blush, it seems a back-door resurrection of the excised “plain vanilla” rules that sought to privilege certain forms of standard form mortgages (by according safe harbor) over others.<sup>119</sup> That is, by defining qualified mortgages to exclude negative-amortizing mortgages, ones with certain high balloon payments, etc., Dodd-Frank effectively privileges the residuum by according them a rebuttable presumption of demonstrated ability to repay. It is not complete safe harbor from statutory scrutiny, to be sure, but exemption (or, more precisely, rebuttable exemption) from one of its more significant and transformative requirements. On the other hand, the privilege is perhaps a hollow one, because in the multi-pronged definition of “qualified mortgage” lies the express criterion of compliance with the Fed’s guidelines and regulations relating to DTI (which surely stands in as a regulatory proxy for ability to pay).<sup>120</sup> Thus mortgages that have a demonstrated ability to pay through Fed guidelines are rebuttably presumed to have an ability to pay! (Perhaps this is not gibberish; for example, were the Fed to decline to issue any DTI guidelines at all, then the safe harbor would presume ability to pay for otherwise qualified mortgages, and hence the privileging would be doing some work. But if we anticipate a subversive Fed trying to undermine the Act through refusal to pass guidelines, why would such an Evil Fed not just exercise its regulatory power to define “qualified mortgage” more broadly to exempt everything?)

In lobbying against the imposition of a suitability standard, the Mortgage Bankers Association warned against the perils of a “subjective” standard of suitability, taking the

---

<sup>117</sup> *Id.* at § 1412, 124 Stat. 2145-46.

<sup>118</sup> *Id.* at § 1412(b)(3), 124 Stat. 2148.

<sup>119</sup> *See supra* note 3 at 9-10.

<sup>120</sup> *See* Dodd-Frank, at § 1412(b)(2)(A), 124 Stat. 2145-46.

position (as a back-up to rejecting the suitability standard altogether) that were a federal intervention required it would have to be “clear and objective,”<sup>121</sup> *i.e.*, a rule. (It also insisted that any mortgage reform not entail a private right of action as a remedy, although one fails to see how this follows from its insistence on objectivity over subjectivity.)<sup>122</sup> Yet at the same time it lobbied against subjectivity in opposing a standard such as suitability (and, by analogy one assumes, ability to repay), the MBA also railed against the dangers of a DTI ceiling of 45%.<sup>123</sup> Some rules are apparently better than others. Section 1412 clearly indicates that the Fed could indeed say a borrower with a DTI above 45% lacks ability to pay, and so perhaps the most significant interpretative impact of the styled “rebuttable presumption” of ability to pay is not so much its content (which could be rendered meaningless) but its explicit countenancing of specific rules, such as DTI caps, that so frightened regulators in the UK.

Accordingly, my conjecture is that as Dodd-Frank unfolds, we will see the proliferation of many specific rules and formulas that in turn will be revised over time. That is, in prognosticating on the rules-standards continuum, I see rules rising ascendant. My prediction stems from a culmination of factors: first, the specific cue in section 1412 to embrace such rules as a DTI ratio;<sup>124</sup> second, the proliferation of prohibitory rules already in the statute (*e.g.*, ban on prepayment penalties for unqualified mortgage,<sup>125</sup> ban on usury laws,<sup>126</sup> etc); third, the conceptually contagious “niggling” provisions of the express statutory text, such as 129C’s insistence on which types of tax documents to examine in underwriting a debtor’s loan;<sup>127</sup> fourth, baseline hyperactivity of newly created and newly invigorated federal agencies;<sup>128</sup> and finally, bureaucratic hindsight conviction that the recent housing collapse might have been avoided had we simply retained rules like the pre-1982 hard LTV caps on residential mortgages.<sup>129</sup> One can even envision categorical bans of certain products (the analogy of the

---

<sup>121</sup> Hirsch, *supra* note 47, at 27 (quoting lobbying positions).

<sup>122</sup> *Id.*

<sup>123</sup> *Id.*

<sup>124</sup> Dodd-Frank at § 1412(b)(2)(A)(vi), 124 Stat. 2146. Technically, one might envision a Fed regulation banning an “unreasonable DTI” (*i.e.*, a standard), but that border on silly. Then again, in interpreting CARD, the Fed only required vague “consideration” of DTI. *See infra*, note 131.

<sup>125</sup> *See* Dodd-Frank at § 1414(a)(c)(1)(A)-(B), (a)(c)(3) 124 Stat. 2149-50.

<sup>126</sup> *See id.* at § 1027(o), 124 Stat. 2003

<sup>127</sup> *Id.* at § 129C(a)(4), 124 Stat. 2143.

<sup>128</sup> The activity level of an agency will depend on its head, a point emphasized in the ABA’s talking points. **(Cite remarks?)**

<sup>129</sup> Vincent DiLorenzo offers interesting analysis on whether Dodd-Frank signals an end to what he contends was the disastrous “principles-based” standards approach that prevailed after 1982. He sees Dodd-Frank as clearly “two steps forward” toward the resurgence of rules, but also feels the blanket quasi-cost-benefit constraint on generating new regulations, *see* Dodd-Frank at §1031, 124 Stat. 2005-06, as “a step backward” toward standards. *See* DiLorenzo, *supra* note 16, at 62-66, 81-83.

accredited investor rule from securities law's Regulation D comes to mind).<sup>130</sup> The power of the Fed to expand and contract the definition of a "qualified mortgage" as it sees fit surely suggests the lesser power to pass such categorical rules banning products it sees as generating an inherent risk of inability to pay.<sup>131</sup>

How else might an "ability to pay" duty be operationalized? One area that has confronted this problem recently has been bankruptcy law, where the 2005 amendments to the

---

<sup>130</sup> Note that the interim CFPB head likes categorical rules. "It is impossible to buy a toaster that has a one-in-five chance of bursting into flames and burning down your house. But it is possible to refinance an existing home with a mortgage that has the same one in-five chance of putting the family out on the street." Warren, *supra* note 99, at 8.

<sup>131</sup> Limited but nevertheless useful insight can be gleaned from the regulations just promulgated under CARD that seek to provide guidance on the duty to assess "ability to pay" prescribed in that statute. The Fed took its crack with Proposed Rules in October 2009 and followed up with Final rules in February 2010. The regulations provide credit card lenders with a safe harbor if they assess repayment following certain assumptions, which include that the full line of credit is drawn for new accounts and that the "real" APR (not the teaser) is applied, but do not assume any fees are incurred (other than mandatory ones such as annual ones) for fear they are "too speculative." Truth in Lending, 74 Fed. Reg. 54124, 54127, 54160-61, 541225-26 (Oct. 21, 2009) (proposed rule), 75 Fed. Reg. 7658, 7660, 7721-22, (Feb. 22, 2010) (final rule) (The inclusion of annual fees came after protest over the "no fees" aspect of the Proposed Rule.) 75 Fed. Reg. 7722. Safe harbor does not require verification of income, assets, etc., as is mandated under Dodd-Frank, because such a requirement is "burdensome," finds the Fed, especially for telephonic applications, plus there is "no evidence" of income-inflating liar loans in the credit card market. 74 Fed. Reg. 54161, 75 FR 7721. Most toothlessly, alas, the "ability to pay" analysis only requires scrutiny of the ability to make the minimum monthly payment, not (as suggested by one commentator on the Proposed Rules) scrutiny of payment that amortizes the loan within a reasonable period of time. This omission was grounded in part on statutory text of the specific "ability to pay" provision in CARD. 74 Fed. Reg. 54127, 75 Fed. Reg. 7721.

One recurrent comment after the Proposed Rules came out was for "more guidance" on just how to measure ability to pay. This resulted in the Fed's inclusion in the final rule of two interesting additions. First, at the prodding of consumer advocates, numerical ratios were injected: lenders must now "consider" the borrower's debt to income ratio, debt to assets ratio, or "residual income" (defined as the income left after the debtor services debt – but not living expenses, so perhaps this is "quasi-net income"), although there is no specific trigger of what might constitute an excessive ratio. 75 Fed. Reg. 7660. Second, at the pushing of industry, the Fed allowed the use of "reasonable policies and procedures" to estimate a borrower's "obligations" in assessing ability to pay, including income and asset estimates based on "empirically derived, demonstrably and statistically sound models." 75 Fed. Reg. 7660, 7718, 7720. The Fed's discussion of the rules reveals strong lobbying and a clear aversion by industry to conduct individual borrower analysis beyond credit score review, modeling, and other quantitative algorithms. Cf. Ruth Simon, *Banks Get Back to the People Business*, WALL STREET JOURNAL, at C1 (March 7, 2011) (discussing return to "character analysis" in loan underwriting in addition to numerical scoring). (One worries about reliance on statistical models after the financial collapse of 2008, but maybe the Fed envisions a brave new world of even bigger, more unsinkable, models.) It is interesting to note that these rules were being finalized during the jockeying over Dodd-Frank, which may explain the incorporation of greater specificity into that statute's text that follow wording from the Fed's regulations interpreting CARD (e.g., "residual income").

Bankruptcy Code under BAPCPA mandated an “ability to pay” screen for chapter 7 (liquidation) bankruptcy through revised 11 U.S.C. s. 707(b).<sup>132</sup> There, Congress took two approaches to measuring ability to repay debts in the bankruptcy context: a gross income screen and a net income screen. For gross income, the statute deems bankrupt debtors unable to repay their debts as a matter of law if they earn less than the applicable state median gross income.<sup>133</sup> For net income, the statute specifies a highly detailed and routinized test of permissible budgetary expenses that is largely driven by IRS guidelines used by field agents negotiating repayment schedules with tax delinquents.<sup>134</sup> What the brief experience of BAPCPA to date has taught us, however, is that even a highly routinized “means tests” crafted by ex ante rule can create a maelstrom of ex post litigation. For example, in the few years since its effective date, already three means test statutory disputes have required Supreme Court intervention.<sup>135</sup>

This ominous BAPCPA lesson could lead to several possible outcomes. First, it might embolden the Fed to seize upon per se gross income rules, deeming some products categorically off limits for certain income demographics (or categorically permissible for others). Second, it could be ignored (or passingly acknowledged) by a resolute Fed ready to bite the bullet of crafting net income rules.<sup>136</sup> Note that England, for all its insistence of not wanting to have hard and fast rules like LTV or DTI caps, apparently believes it will be able to police an obligation on lenders to calculate “free disposable income,” a number that includes deductions for “committed expenditures for the borrower’s and borrower’s dependents (income tax, national insurance, utility bills, alimony and maintenance payments, school fees) as well as personal expenditures (food, clothing, health and personal care, transport, recreation and holidays).”<sup>137</sup> As such, the Fed might use the UK as a guinea pig in coming up with its own BAPCPA-like list of deductions in getting to the appropriate “income” that grounds the ability to

---

<sup>132</sup> Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-08, § 707, 119 Stat. 27 (2005).

<sup>133</sup> *Id.* at § 707(b)(6)-(7); *cf.* § 707(b)(3) (re-imposing ability to pay for means-test passers under certain circumstances).

<sup>134</sup> *Id.* at § 707(b)(2)(A)(ii)(I)-(V) (“The debtor’s monthly expenses shall be the debtor’s applicable monthly expense amounts specified under the National Standards and Local Standards, and the debtor’s actual monthly expenses for the categories specified as Other Necessary Expenses issued by the Internal Revenue Service . . .”).

<sup>135</sup> See *Ransom v. FIA Card Services, N.A.*, 131 S. Ct. 716 (2011); *Milavetz, Gallop & Milavetz, P.A. v. U.S.*, 130 S.Ct. 1324 (2010), *Hamilton v. Lanning*, 130 S. Ct. 2464 (2010).

<sup>136</sup> This seems unlikely based on the experience of the new CARD amendments to Regulation Z, discussed *supra* at note 131. There, the Fed initially suggested that lenders be required to consider a debtor’s “obligations” in gauging ability to pay in its proposed rules, but then when pressed for more guidance in the final rules, simply pointed to analyzing either specific financial ratios such as DTI and DTA or something it called “residual income,” which was defined as income after service of debts (which is better thought of as “quasi-net income”).

<sup>137</sup> Mortgage Market Review, *supra* note 93, at 16, 23.

pay analysis. (It is also, of course, possible the Fed learns the ultimate BAPCPA lesson and tries to fob everything off to the IRS.)<sup>138</sup>

Complicating the analysis of what ability to pay regulation will look like is the issue of pre-emption. Weighing in on a long-fought battle,<sup>139</sup> Dodd-Frank makes clear that federal pre-emption of state consumer protection laws is lifted; federal law is to become a “floor” from which more consumer-protective states are free to depart upward.<sup>140</sup> This raises the prospect that some practices that survive categorical proscription at the federal level may nevertheless be banned by specific states (so long as not creating an actual conflict). Compounding this potential confusion is the restriction on remedies. One of the fighting lines in the battle over Dodd-Frank was the creation of a private right of action for consumers,<sup>141</sup> which was resolved in favor of industry by omitting such relief. But the new pre-emption rule now implies a state could permit its own consumer protection laws that do allow private rights of action to persist and grant consumers newfound powers, liberated from the yoke of federal pre-emption. (Indeed, Dodd-Frank’s resurrection of assignee-liability suggests that even more putative defendants will be added to the mix than perhaps previously imagined.)<sup>142</sup> The final aspect of this wildcard is the rollback of mandatory arbitration.<sup>143</sup> Not only will many matters of dispute now reach court for public, media-attracting resolution, but the full judicial powers of preclusion and precedential effect will attach. Accordingly, while I foresee myriad rules coming out of the regulatory maw in the upcoming years, I cannot foreclose at the same time the interpretation of those rules (or similar, stronger state ones) effectively being transferred to, or perhaps even hijacked by, the courts. (Imagine at the extreme a resurgence of the heady 1960’s unconscionability caselaw.)<sup>144</sup>

In final analysis, then, notwithstanding the pre-emption and private action wrinkles, the most likely implementation of the new ability to pay duty will be a proliferation of constantly updating rules emanating from the Fed. Naysayers, of course, predict whatever comes out will be indecipherable: “We have such nebulous terms as ‘reasonable ability to repay.’”<sup>145</sup> But

---

<sup>138</sup> Note that either path would be consistent with a prediction of rules-orientation.

<sup>139</sup> See *Watters v. Wachovia Bank, N.A.*, 127 S. Ct. 1559 (2007).

<sup>140</sup> (Cite.)

<sup>141</sup> (cite remedies part of Dodd-Frank.) For discussion of the private action battle, see Hirsch, *supra* note 47, at 27.

<sup>142</sup> See Dodd-Frank at §1404, 124 Stat. 2141.

<sup>143</sup> *Id.* at §1414(e), 124 Stat. 2151.

<sup>144</sup> See, e.g., *Williams v. Walker-Thomas Furniture*, 350 F.2d 445 (D.C. Cir. 1965).

<sup>145</sup> 111 Cong. Rec. H5182 (2009) available at <http://www.gpo.gov/fdsys/pkg/CREC-2009-05-06/pdf/CREC-2009-05-06-pt1-PgH5179-2.pdf> (Rep. Hensarling).

those are cheap shots. As discussed above, suitability standards have been around for decades in securities law, and somehow that system has survived.<sup>146</sup>

### III. Comment: What Does It All Mean?

Whatever its form of implementation, the question arises whether shouldering banks with a requirement to assess their customers' ability to pay will be all that big deal. It will. This is so both for the actual doctrinal effect as well as the broader expressive significance. The actual doctrinal effect will unfold through the effective nationalization of underwriting standards that the Fed will exercise under its new regulatory powers.<sup>147</sup> That is a return to 1982. The broader conceptual leap (as we saw with England's crumbling resistance to "responsible lending") lies in dispatching the fictions that acquiring a suitable mortgage is fully up to the borrower alone and that assessing its rightful fit is up to him alone too as an arms-length contractual counterparty. Relatedly, the duty to analyze ability to repay constitutes recognition of the failure in relying upon market forces alone to discipline lenders (i.e., admitting the natural profit motives of lenders did not assure the extension of credit to repayment-likely borrowers). A duty – an affirmative mandate imposed by the state – now lies on mortgage lenders to assure their erstwhile contractual adversaries can pay back their loans. The imposition of this new, proto-fiduciary duty fundamentally changes the landscape of how we understand the debtor-creditor relationship in the consumer realm. This transformation is significant, but it comes of course with two very likely consequences: first, an increased paternalistic regulatory mindset (pejoratively, the rise of the "nanny state"), and second, reduction/rationing in mortgage credit.

Lest there be any doubt, paternalism was Epithet Number One hurled at Dodd-Frank in the battles over its passage. As one opponent railed, "This is Uncle Sam telling you, with a couple of exceptions, if you can't qualify for a 30-year fixed mortgage, then we are going to deny you the homeownership opportunity in America, because we are smarter than you. We know better than you. We have to protect you from yourself."<sup>148</sup> Condemned another, "That is not the American Dream; that's the Government Dream."<sup>149</sup> The title of one prominent jurist's Op Ed said it all: "Treating Financial Consumers as Consenting Adults."<sup>150</sup>

Dodd-Frank is paternalistic – highly so. Supporters can squirm at this attribute as a necessary evil, distract critics with the panglossian distinction between "libertarian" and

---

<sup>146</sup> Although I must confess to being a non-expert in securities law. Conducting the rich empirical research of asking a colleague who is, I was informed that the Finra arbitrations are actually quite useless in crafting standards for "suitability," because the arbitrators are usually poorly versed in underlying securities laws and norms.

<sup>147</sup> A co-participant at a recent conference on the CFPB gets credit for the insight that ability to pay is effectively a compulsory underwriting term.

<sup>148</sup> 145 Cong. Rec. at H5182 (Rep. Hensarling).

<sup>149</sup> *Id.* at H5183 (Rep. Neugebauer).

<sup>150</sup> See Posner, *supra* note 108. **(Could critique Op Ed's "ridiculous" examples as actually quite likely.)**

“ordinary” paternalism,<sup>151</sup> or otherwise try to deflect this charge by changing the subject. But the better approach is to confront it head on and celebrate the law’s inherent paternalism. After all, the evil (for those who see it as an evil) of paternalism lies in reducing the autonomy and dignity of private contracting actors.<sup>152</sup> But if the market is malfunctioning,<sup>153</sup> and especially if the basis of that malfunction is in part deception, then the autonomy concerns largely evaporate.<sup>154</sup> (As for the sub-debate of “strong” vs. “weak” paternalism,<sup>155</sup> I can nudge the reader into considering the emerging draft of the EU Directive on Responsible Mortgage Lending. Under that proposal, mortgage lenders will be burdened with a suitability duty toward their borrowers, but the duty will be waiveable with sufficient disclosure.)<sup>156</sup>

The second grievance with the new ability to pay duty is simply the well known lament of usury law opponents: reduction in credit availability, either through pernicious substitution or outright rationing. “The more likely result of stricter mortgage origination rules is a return to rationing, which could result in lower overall homeownership since some of the recent increase in homeownership was due to the ability of subprime borrowers to access credit.”<sup>157</sup> This worrying even made it into the legislative debates. One opponent complained, for example, that “this bill . . . will functionally be taking away homeownership opportunities from American people. . . . So, ultimately what we are going to have are fewer mortgages being made.”<sup>158</sup>

---

<sup>151</sup> See *id.* (“Mr. Thaler, whose views are taken seriously by the Obama administration, calls himself a “libertarian paternalist.” But that is an oxymoron. He is a paternalist with a velvet glove—as the agency will be.”)

<sup>152</sup> For a nice roundup of Kantian concerns, see Seana Valentine Shiffrin, *Paternalism, Unconscionability Doctrine, and Accommodation*, 29 PHIL. & PUB. AFF. 205, 220 (2000) (discussing concern that paternalistic legal interventions accord “insufficient respect for the underlying valuable capacities, powers, and entitlements of the autonomous agent”).

<sup>153</sup> Note too that the economics of the subprime market are fiercely contested. For example, in a scholarly debate on the merits of regulatory intervention, both Engel & McCoy and Zywicki & Adamson lay greater claim to Stiglitz & Weiss’s informational asymmetries. See Engel and McCoy, *supra* note 59, at 1258, 1278, 1280-84; Zywicki and Adamson, *supra* note 106, at 71, 73, 78-82. The latter claim that their basic model suggests it is madness to saddle the lender with a duty to know the private information of the borrower, while the former retort that the complexity of current credit instruments and sophistication of credit scoring algorithms actually do diminish (and arguably reverse) the asymmetry.

<sup>154</sup> See John A. E. Pottow, *Private Liability for Reckless Consumer Lending*, 2007 U. ILL. L. REV. 1, 454-55 (exploring paternalism critiques to consumer credit regulation).

<sup>155</sup> See, e.g., Cass R. Sunstein and Richard H. Thaler, *Libertarian Paternalism is Not an Oxymoron*, 70 U. CHICAGO L. REV. 1159 (2003).

<sup>156</sup> See *Working Paper*, *supra* note 91, at 8-9.

<sup>157</sup> Zywicki and Adamson, *supra* note 106, at 78.

<sup>158</sup> 145 Cong. Rec. at H5181-82 (Rep. Hensarling).

Another predicted that homeownership after Dodd-Frank will be made “more expensive and less available to those people who need it the most.”<sup>159</sup>

Again, the appropriate rejoinder to this rhetoric is direct admission and confrontation. One of the intended consequences of Dodd-Frank is for fewer people to acquire mortgages – those who lack the ability to repay them in the cold calculus of rigorous underwriting. Of course there will be errors, both Type I and II. The question is whether one type is preferable to the other. The mantra of increased homeownership as an intrinsic social good presumes the former are better than the latter, but that is far from clear. On the contrary, the spillover effects of the housing collapse – shown in the dropping property values of the non-foreclosed neighbors – has sharpened our appreciation of the dangers of “false grantings” of mortgage credit. Even staunch critic Jack Guttentag admits, “Perhaps the costs associated with borrowers who fail [in their mortgages] – costs to both themselves and their communities – more than offset the benefits to those who succeed.”<sup>160</sup> (And this worry was published in 2007, when the ice was just beginning to crack.) Accordingly, rather than awkwardly tap-dance around the reduction in mortgage origination possible from Dodd-Frank’s elimination of asset-based mortgage lending, I embrace it.

### **Conclusion**

While they are not fiduciaries, mortgage lenders are now no longer arms-length contractual counterparties: they have a duty to assess a prospective borrower’s ability to repay her loan. Reliance on the asset value alone, or on flipping the debt to another through securitization, will no longer suffice. This dramatically transforms the debtor-creditor relationship in the residential mortgage market. This article has tried to chart the source of this innovation by showing how it did not spring fully formed from Chris Dodd’s head. Lenders’ duties of “responsible lending” (in the European parlance) have a rich pedigree, both domestic and foreign. The article also offered conjecture as to how this new duty will unfold in the United States, predicting a swath of new technical rules of great specificity from appropriate agencies. Finally, it briefly registered its alignment with the supportive normative camp: Dodd-Frank is not just a big deal for the mortgage markets, but a good deal. Properly interpreted, the duty to analyze ability to repay could re-align the residential mortgage market and ensure that 2008 becomes a closed chapter in commercial law history.

---

<sup>159</sup> 111 Cong. Rec. H5176 (2009) (Rep. Sessions), *available at* <http://www.gpo.gov/fdsys/pkg/CREC-2009-05-06/pdf/CREC-2009-05-06-pt1-PgH5174-3.pdf>.

<sup>160</sup> Guttentag, *supra* note 106.