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THE SHIFTING FOUNDATIONS OF FINANCIAL REGULATION

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INTRODUCTION

Financial regulation in the U.S. and around the world has changed dramatically since the 2007-2008 financial crisis. There are many visible manifestations of the changes, including Dodd-Frank, Basel III and, other laws. In this paper, I will discuss what I believe are two important recent changes in our approach to financial regulation and how they are reflected in recent laws and in new regulatory authorities. This article will discuss both of these changes broadly, but will also focus on how they are reflected in regulation by the new Consumer Financial Protection Bureau (CFPB).

The first change is an increasing reliance on regulator judgment and discretion rather than on hard and specific rules and regulations. Hard rules are not disappearing from current regulation; for example, Basel III capital requirements and the definition of qualified mortgages are hard rules. But recent financial regulation does grant extraordinary discretionary powers to regulators.

The second change is an increasing reliance on behavioral economics to motivate and justify regulation. Traditional motivations for financial regulation have relied on market failure. Behavioral economics suggests that individuals’ inability to make rational and intelligent choices makes paternalistic financial regulation desirable.

THE SHIFT TOWARD INCREASED REGULATOR DISCRETION

Hard Rules Versus Discretion

Hard rules are unambiguous rules about what a financial institution or market participant must do or cannot do. Both regulators and financial institutions know about these rules before actions are taken and know what the institution must do to be in compliance. For example, under Basel III, if a bank holds sovereign debt from a country with a country risk...
classification of 4-6, the risk-weighing factor for the debt is 8%. This tells both the bank and regulator exactly how much equity capital a bank must hold against sovereign debt with this level of risk. There is no ambiguity, and the regulatory requirement is known in advance.

As another example, insiders are defined as a company’s officers, directors, and owners of more than 10% of the company’s stock. Any sale of stock by an insider must be reported to the SEC within two business days of the sale. Who qualifies as an insider and what they must do when they sell stock is clear in advance.

Recently, we have seen a move away from hard rules and toward more regulator discretion. Rather than using hard and fast rules that are known in advance, regulators are making decisions based on broad regulatory goals and their individual judgment. This is not to say rules are not being written and enforced—far from it—but regulator discretion seems to be becoming more important.

One familiar example is in the designation of non-banks as Systemically Important Financial Institutions (SIFIs). SIFIs are institutions whose failure could threaten the financial stability of the United States. Companies designated as non-bank SIFIs include AIG, General Electric Capital, Prudential Financial, and MetLife. A SIFI designation means the company comes under the supervision of the Federal Reserve, is subject to capital requirements, needs to make regular living wills, and may be subject to the Volcker rule. It is a big deal, and companies like Blackrock and Fidelity Investments have made great efforts to avoid being named non-bank SIFIs.

The Financial Stability Oversight Council (FSOC) determines whether or not an institution is a SIFI. They do not have specific rules or metrics to determine non-bank SIFIs. In response to calls for more transparency in the designation process, the FSOC has said,

Due to the unique threat that each nonbank financial company may pose to U.S. financial stability and the qualitative nature of the inquiry under the statutory considerations, it is not possible to provide broadly applicable metrics defining these channels or to identify universally applicable links between the channels and the statutory considerations.

2. Id.
4. DELOITE, SIFI DESIGNATION AND ITS POTENTIAL IMPACT ON NONBANK FINANCIAL COMPANIES 8-10 (2013).
In other words, we cannot define a SIFI, but we know one when we see it.

A second well-known and important example of regulator discretion is the design of bank stress tests. Dodd-Frank calls for forward-looking stress tests for large banks. These tests are simulations of unlikely but plausible macroeconomic situations. To pass a stress test, a bank needs to maintain minimum capital levels in the simulation. Failure to pass a stress test has serious consequences. The bank will probably have to cut back or even eliminate its dividend to increase its capital. News that a bank has failed a stress test, as Citigroup or Zion’s Bancorp did in 2014, is usually accompanied by a significant decline in the bank’s stock price.

Regulator discretion comes into play in the design of the stress test. Banks are not given information on the simulated macroeconomic situation in advance. They cannot make changes to their balance sheets to help pass the stress test.

I believe that there are two reasons why we are moving toward more regulator discretion and away from hard rules. The first is that financial markets and institutions are much more complex than they were just a few years ago, and financial innovation is taking place at a more rapid rate. Complexity and change makes it more difficult to write widely applicable rules.

The second reason for the increased reliance on regulator discretion is political. The Federal Reserve, the SEC, the Comptroller of the Currency, and other regulators avoided blame for the financial crisis by claiming that they either lacked information or lacked authority to prevent the crisis. The formation of FSOC is intended to make sure regulators have information about the financial system as a whole. Greater discretion is intended to make sure they have the authority to prevent a crisis.

Advantages of Regulator Discretion Over Hard and Specific Rules

There are advantages and disadvantages of depending on regulator discretion rather than hard rules. One of the advantages of regulator discretion is that rules can be gamed. A bank holding company with consolidated assets in excess of $50 billion is deemed a SIFI and is subject to more stringent regulatory standards and requirements than smaller

banks. Banks can get around a hard rule like this by selling assets, and accountants can do many, many things to reduce the value of their consolidated assets below $50 billion. The hard rule can be gamed. On the other hand, regulators can simply designate a non-bank financial institution as a SIFI. Accounting tricks can’t be used to avoid the designation.

A second advantage of regulator discretion rather than specific rules is that innovation and technological change can be used to eventually circumvent rules. ATMs for example, can be thought of as a technological innovation that makes banking services more convenient for customers. While ATMs do indeed do that, they were also a way to circumvent restrictions on bank branch offices. More recently, Dodd-Frank’s new margin requirements on swaps have been circumvented through “futurization.” That is, much of the swap trading has migrated to futures on swaps—an economically equivalent derivative contract with lower margin requirements. This cycle of financial regulation, innovation, and reregulation is termed the regulatory dialectic by Edward Kane. Regulator discretion can adapt to financial innovation quickly, while rules are rewritten with a much longer time lag.

Finally, an advantage of discretion is that, broadly speaking, rules are based on a subset of the information available to the regulator. They do not incorporate any special considerations that may apply in a particular case. They do not incorporate innovation that has occurred since the rule writing.

Problems with Regulator Discretion

There are also significant problems with giving regulators too much discretionary power. One is that an absence of specific hard-and-fast rules creates uncertainty. For example, banks that are subjected to annual stress tests by the Federal Reserve do not know the nature of the stress tests beforehand. This eliminates banks’ ability to game the tests, but also creates uncertainty. Will they pass? Can they afford to pay a dividend? Can they afford to make an acquisition that will expose them to more risk from Asian markets? This uncertainty can affect banks’ business decisions in the weeks and months leading up to the stress tests.

Another example of uncertainty is in the designation of SIFIs. Because it relies on regulator discretion, financial institutions cannot game SIFI

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9. The Dodd-Frank Wall Street Reform and Consumer Protection Act, Section 165 (a)(1) of H.R. 4173.
designation. At the same time though, they do not have clear guidance on how to avoid being named a SIFI. Firms may make costly and unnecessary or unsuccessful changes to their businesses in an effort to avoid a SIFI designation.

A second problem with relying on regulator discretion is that regulators’ intelligence and judgment, and the information that is available to them, is limited. The financial system is very complicated, too complicated for any individual to understand completely. It is naïve to expect regulators to be able to foresee and prevent all future financial crises. They’re not that smart. Nobody is. Giving more discretion to regulators can give a false sense of security.

In retrospect, it is easy to see that mortgage-backed securities were overpriced in 2008, and that financial firms that held large quantities of them were at risk of failure. Had this been apparent at the time, smart investors, say hedge fund managers, could have made many millions of dollars betting against mortgage-backed securities. But they did not. Richard Fuld, former CEO of Lehman Brothers bet big on mortgage-backed securities through Lehman and personally lost almost $1 billion.13 Are regulators really smarter than the people on Wall Street that lost money during the financial crisis?

Perhaps the biggest problem with relying on regulator discretion rather than hard rules is that it makes it easier for regulators to pursue their own self-interest. Giving regulators discretion gives them power. Most use it benignly in what they perceive to be the public interest. However, some just enjoy wielding power. Alternatively, they can use it to generate publicity for themselves to jumpstart a political career. They could do this, for example, through high profile enforcements against unpopular financial institutions. Or, regulators could use their discretionary powers to extract perks or favors from the financial industry, including lucrative jobs in the private sector after their regulatory career ends. The financial sector has no incentive to curry favor with bureaucratic regulators who merely check boxes that rules are met. It is the regulator’s discretion that makes businesses attempt to influence him or her.

Finally, more regulatory discretion means more lobbying and more meetings with regulators and politicians. Before rules are written, financial firms typically meet with regulators to inform them about the likely impact of rules and about alternative measures that could satisfy the regulators’ objectives. These activities are costly for both regulators and regulated firms. After a rule is written though, the lobbying and meetings are done. When regulators have discretion, the meetings never end.

BEHAVIORAL ECONOMICS AND CHANGING REGULATORY OBJECTIVES

The Approaches of Traditional and Behavioral Economics Toward Regulation

The second change in our approach to financial regulation is, I believe, a result of the increasing acceptance of behavioral economics. Traditional economic theory assumes individuals are rational. Economists, of course, know that people are not always rational, but rationality is a good approximation and markets push people toward rational choices. The assumption of rationality allows economists to produce useful models of markets and economic behavior that yield clear predictions.

The traditional economic rationale for financial regulation is to remedy market failures. A familiar example is bank runs. Banks get funds from checking and saving accounts that can be withdrawn at any time. They invest in mortgages and other illiquid long-term assets. Suppose that depositors believe a bank is sound but fear that other depositors think it is insolvent. Depositors have an incentive to withdraw money before others. If they wait, the bank may not have cash and may not be able to give them their money until they sell mortgages. If the bank has to sell its illiquid assets quickly, it may not be able to get the full value for them. Depositors may only receive a portion of their money back. So, a perfectly safe, solvent bank can be driven out of business by a bank run.

This market failure is resolved by FDIC insurance. When depositors know their accounts are fully insured, the incentives for bank runs disappear. This market distortion creates other problems though, which require additional regulations. With deposit insurance, banks can borrow cheaply regardless of how many risks they take in their mortgages and other investments. This heads-we-win, tails-the-FDIC-loses situation creates an incentive for banks to take inappropriate risks. So, among other things, regulations limit the investments banks can make and the capital they must hold.

The previous example illustrated financial regulation based on traditional economics and its assumption that bank depositors are rational. Behavioral economics, on the other hand, has its roots in psychology.14 Work in behavioral economics and behavioral finance demonstrates that investors have limited cognitive abilities and numerous clear biases in the way they process information and assess probabilities.15 Individuals, for example, are overconfident about both their abilities and their knowledge.

They are also affected by anchoring, a fact that is well known to skilled negotiators. If negotiations to buy a car start at the sticker price, they are anchored there and the final price will be higher than if negotiations start at the price the dealership paid for the car. Framing, or how a decision is presented, also affects individuals’ decisions. Equivalent choices described in slightly different ways lead individuals to take different actions.

Behavioral researchers have also discovered biases in the way that individuals assess probabilities. The likelihood of low probability events is usually overestimated. Individuals ignore base rates. They are unable to update probabilities correctly when new information is received. They sometimes claim that both event A and event B occurring is more likely than event A. Behavioral economics has been characterized as a “theory of errors.”

These findings are but a handful of the reasons why individuals can be expected to make suboptimal decisions. Traditional economics says that regulation is needed because markets fail under certain circumstances. Behavioral economics says that regulation is needed because individuals consistently fail to make good financial decisions.

So, behavioral economics suggests that protecting investors or other financial decision makers is an important reason for regulation. Traditional financial regulation has also tried to protect investors. To achieve this, the SEC’s long-time approach has been to insure that companies release complete and accurate information in a timely manner. Behavioral finance would hold that this is not enough. Even with accurate and timely information, investors make bad decisions. Instead, regulators can improve welfare with paternalistic policies that force individuals to make specific financial decisions.

Advantages and Disadvantages of Paternalism

Consider, for a moment, hard paternalism where regulators determine what is best for individuals. There are some positive things to be said about this approach to financial regulation. It may prevent some people from making bad decisions. It may save individuals the time that it takes to become informed about financial products that they would ultimately reject.

Many people have philosophical problems with paternalism. They see it as a threat to liberty. They believe that controlling one’s own destiny, much more than making correct financial decisions, is essential for happiness. These are important issues, but we will not address them here. Instead, we

will discuss why paternalistic regulations that prevent individuals from making some financial decisions or using some financial products may not yield the best financial outcomes.

One problem is that regulators do not have all the information about individuals’ situations that the individuals themselves possess. Individuals make decisions based on the particulars of their current situation. A financial product that may be inferior for most people on most occasions may in fact be right for some individuals at some times. So, in some cases, policy may attempt to correct seemingly irrational decisions that are, in fact, rational when all of the facts of a person’s situation are known. It may also place costly restrictions on rational people from policies designed to help the irrational.  

A second problem is that regulators are afflicted with the same psychological biases that plague everybody else. These biases may be diminished by the regulators’ expertise and experience, or because the regulator can be more objective in recommendations to others than people can be when making their own decisions. On the other hand, people overestimate their own competence and underestimate the competence of others. Regulators are not immune to this bias. And people just love to tell other people what to do. This suggests that regulators may not hesitate to promote financial products that may not, in fact, be optimal for the particular person or situation.

Another problem of paternalistic regulation is that it may discourage innovation. Banks and other financial companies may be reluctant to create new products that may not be approved by regulators or that might be subject to a long approval process. They may also be reluctant to create financial products that are useful for some people but may be misused by others.

Finally, if paternalism pushes individuals into particular financial products or services, it may prevent them from gathering information about alternatives. At first blush, this seems like an advantage of paternalism. After all, why should multiple people bear the cost of becoming informed rather than a regulator bearing the cost once for everybody? But, people are different and have different needs. Furthermore, they pass information on to each other. One person’s choice to become informed may provide positive externalities to many people.  

Some of these problems of paternalism can be overcome if regulators allow individuals to make their own financial choices but “nudge” them toward making what the regulators believe to be the best ones. Cass

19. Id. at 1049.
Sunstein, an advisor to the Obama Administration, and Richard Thaler, one of the founders of behavioral economics, make the case for what they refer to as “Libertarian Paternalism.”21 In their view, individuals can be “nudged” toward making wise decisions while giving them the choice to opt out and make other choices. An example would be the choice of contributions to 401(k) plans. Most plans allow employees to opt in to the plan, but Sunstein and Thaler argue that they are more likely to make the correct choice of contributing to a 401(k) plan if they have to actively choose to opt out.22

Sunstein and Thaler present a subtle argument for Libertarian Paternalism. The way in which employers, investment advisors, or financial institutions present choices has a strong effect on what individuals do regardless of the actual information presented about the choices. Regulators can nudge individuals to make good decisions by requiring certain “choice architectures.” So, for example, making a choice a default choice will increase the likelihood that individuals will choose it. Some choice architecture must be used. Under these circumstances, why not make the best choice the default?

Sunstein claims as a “first law of behaviorally informed regulation: In the face of behavioral market failures, disclosure of information, warnings, default rules, and other kinds of nudges are usually the best response, at least when there is no harm to others.”23 While Sunstein is clearly a proponent of paternalistic regulation, he recognizes objections to it. He recognizes that many people feel autonomy is a desirable thing but claims that most efforts to remedy “behavioral market failures” do not interfere with autonomy, “rightly understood.”24 Hard paternalism is defined as “actions by government that attempt to improve people’s own welfare by imposing material costs on their choices.” Soft paternalism is “actions of government that attempt to improve people’s own welfare by influencing their choices without imposing material costs on those choices.”25 Sunstein believes that soft paternalism, in the form of libertarian paternalism, can preserve individuals’ autonomy while protecting them from their own mistakes.

Smith and Zywicki, on the other hand, suggest that what is a gentle nudge in theory, becomes a hard shove in practice.26 Regulators may find it easier to force people into particular choices.

22. Id.
24. Id. at 1837.
25. Id. at 1860.
In the last few years, libertarian paternalism has gained enormous influence in Washington. In part, this is because libertarian paternalism has been articulately defended in a number of well-cited academic papers. In addition, proponents of this view have occupied prominent regulatory positions. For example, Sunstein headed the Office of Information and Regulatory Affairs in the Executive Office of the President.

REGULATORY TRENDS AND THE CFPB

The CFPB was established in the Dodd-Frank bill. Both of the trends that we have discussed, regulator discretion rather than hard rules and paternalism informed by behavioral economics, have been incorporated into the CFPB’s approach to regulation since its beginning.27

“Making Credit Safer,” an article by Oren Bar-Gill and Elizabeth Warren, is generally acknowledged to be the intellectual father of the CFPB.28 It calls for the creation of a new regulatory agency with “broad rulemaking and enforcement authority over consumer credit products.”29 The CFPB was always conceived of as an agency in which powerful regulators had broad powers to determine acceptable financial products and practices. Regulation of consumer finance, which had been spread across a number of regulators, was to be concentrated here.

In arguing the need for an independent agency to regulate consumer financial products, Bar-Gill and Warren rely on both traditional economic arguments and arguments from behavioral economics. They observe that it may be costly for consumers to become informed about financial products. By itself, this is not a large problem. Consumers invest in information until the expected benefit from investing more is offset by the cost. But Bar-Gill and Warren also note that consumers are imperfectly rational. They may, for example, forego information about credit card late fees in the mistaken belief that they will never make a late payment.

The CFPB and Regulator Discretion

From the start, the CFPB was always envisioned as a regulator with broad discretionary powers. The original Bar-Gill and Warren article notes that “legislation targeted to specific practices . . . is incapable of effectively responding to the high rate of innovation in consumer credit markets and the subtle ways in which creditors can exploit consumer misunderstanding.”30 In other words, individuals cannot be protected unless

29. Id. at 99.
30. Making Credit Safer, supra note 30, at 100.
regulators have discretionary powers.

The CFPB has the power to regulate “unfair, deceptive, or abusive product(s).” These vague, general terms give the CFPB the power to regulate many things. The term abusive, in particular, can be used to give broad discretionary powers to the CFPB. The terms unfair and deceptive have history and precedents in regulation. Abusive is new. It will ultimately be defined through enforcement actions that lead to court rulings. In the meantime, the CFPB decides which policies or practices are abusive, and can bring enforcement actions based on their judgment.

The CFPB interprets its broad mandate to include virtually any financial practice that can be construed as detrimental to individuals. The CFPB’s Education Loan Examination Procedures manual states that, “[t]o carry out the objectives set forth in the Examination Objectives section, the examination process also will include assessing other risks to consumers that are not governed by specific statutory or regulatory provisions.”

The broad discretion given to CFPB regulators to pursue their mandate creates tremendous uncertainty for financial institutions. It is difficult to know in advance which products and services will be deemed abusive and which will be allowed. In some cases, it is likely that this uncertainty will prevent financial firms from providing products or services that would be useful to their customers.

An example of the CFPB’s regulatory discretion in action comes from the CFPB’s attempt to regulate auto dealers. In drafting the Dodd-Frank bill, Congress carved out auto dealers from the CFPB’s jurisdiction. There are not good reasons for doing this. Auto loans represent a large portion of consumer debt. But auto dealers lobbied effectively and the Dodd-Frank bill clearly specifies that they are exempt from CFPB regulation.

So, the CFPB has sought to regulate auto dealers indirectly by regulating lenders who work with auto dealers. When auto dealers arrange financing for car buyers, they typically arrange for a loan from a bank and then mark up the interest rate, so car buyers who arrange financing through a dealer pay more than the rate charged by the lender. A concern for the CFPB has been the interest rate markup charged by dealers above the interest rate charged by the lender.

In March 2013, the agency released a bulletin that warned lenders that they would be responsible if auto dealers discriminated on loan interest

32. CONSUMER FINANCIAL PROTECTION BUREAU EXAMINATION PROCEDURES, EDUCATION LOANS 7 (Dec. 2013).
rates on the basis of race. The race of the loan applicant is recorded on mortgage forms but not on auto loan forms. Lenders do not know the race of the loan applicant. Neither, for that matter, does the CFPB. They instead rely on statistical models based on demographics to predict the applicant’s race and use a disparate impact analysis to determine if minority borrowers were being charged more for car loans. They have crafted a proxy method based on demographics to determine the race of a borrower.

Here is where the use of discretion rather than rules comes into play. Rather than issuing a rule so that lenders can avoid being charged with discriminatory lending, the CFPB is considering some enforcement actions against lenders. If a rule was issued they would have to make it publicly available and their methodology would be described and subject to scrutiny. In addition, the precarious legal basis for their enforcement would be revealed. They are, after all, not supposed to regulate auto dealers.

Here, the costs of discretion are clear. Lenders are not given information that allows them to structure their compliance to avoid discrimination charges. This uncertainty makes them reluctant to loan money. From the standpoint of the lender, the way to avoid legal action is for the auto dealer to charge the same interest rate on each loan. That appears to be the CFPB’s objective.

Giving regulators discretion always carries with it the possibility of abuse. Mark Seidenfeld believes that in many cases, the advantages of regulator discretion outweigh this risk as long as the regulator is subject to ex-post review. The CFPB has been set up in such a way though that it is subject to almost no political oversight. It is run by one director rather than five commissioners like the SEC or Commodity Futures Trading Commission (CFTC). It is housed in the Federal Reserve and is not subject to congressional budgetary review. Its rulings can only be overturned by a two-thirds vote of the FSOC, and only if the rule threatens the financial stability of the United States.

The CFPB and Paternalism

Behavioral economics has been baked into the CFPB from the beginning. The foundational article by Oren Bar-Gill and Elizabeth Warren speaks of the need to protect imperfectly rational consumers. Behavioral economic

38. Id. at 339.
39. Id. at 353.
40. Making Credit Safer, supra note 30, at 157.
views are well represented at the CFPB.

The academic advisory board for the CFPB, which is composed of first-rate scholars, includes behavioralists Richard Thaler and Christine Jolls, a coauthor of Sunstein and Thaler.41

Dodd-Frank authorizes the CFPB to prohibit abusive acts and practices.42 A recent article by Patrick Corrigan contends that the abuse authority gives the CFPB the power to regulate problems arising from irrationality of the type documented by behavioral economics.43 The FTC has long worked to prevent unfair and deceptive practices, but the term abusive is new.44 It is not defined in the law, but section 1031(d) provides minimum standards to the CFPB to apply the law.45 The CFPB can only declare a product or service to be abusive if it:

1 materially interferes with the ability of a consumer to understand a term or condition of a consumer financial product or services; or
2) takes unreasonable advantage of—(A) a lack of understanding on the part of the consumer of the material risks, costs, or conditions of the product or service; (B) the inability of the consumer to protect the interests of the consumer in selecting or using a consumer financial product or service; or (C) the reasonable reliance by the consumer on a covered person to act in the interests of the consumer.46

Inability to understand a product, or to protect one’s own interests is, of course, a major concern of behavioral economics.

Many of the CFPB’s actions appear to be motivated by paternalism. For example, the CFPB believes individuals have trouble understanding their credit cards and seeks to make them more understandable. On their website, the CFPB says, “A credit card agreement describes the structures and features of a credit card. We believe that it is important to make them less complicated so that consumers can better understand their credit cards.” They propose a standardized two-page form.47

The CFPB also takes a paternalistic view of mortgages. Mortgages that

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42. 12 U.S.C. § 5511 (b)(2).
44. Levitin, supra note 39, at 337.
46. Id.
meet certain standards are “qualified mortgages.” Qualifying a loan makes it more difficult to hold the lender liable for failing to make a “reasonable, good faith determination of a consumer’s ability to repay.” Hence from the standpoint of lenders, a big advantage of writing qualified mortgages is that it provides a safe harbor from some kinds of lawsuits. Restrictions on mortgages that allow them to be deemed qualified mortgages include: 1) no negative amortization or interest only payments, 2) no balloon payments, 3) loan term of 30 years or less, 4) a 3% cap on fees and points, and 5) the borrower’s debt-to-income (DTI) must be 43% or less.

Here, the gentle nudge becomes a hard push. There are good reasons for some borrowers to take out mortgages with these provisions. A 40-year mortgage, for example, can reduce monthly payments to a level that allows a borrower to easily make payments. A debt-to-income ratio greater than 43% may be acceptable for a borrower whose income is expected to increase, or who has a lot of assets. The CFPB does not prevent borrowers from taking out mortgages with these provisions, but since they are not qualified mortgages, lenders will be more likely to be sued.

A second part of being a qualified mortgage is that the lender must establish the borrower’s ability to repay. The CFPB’s ability-to-pay rule went into effect in January 2014. Under this rule, for a mortgage to be qualified, creditors must consider eight underwriting factors for a residential mortgage loan to assess the borrower’s ability to repay the loan: 1) current or reasonably expected income or assets, 2) current employment status, 3) the monthly payment on the mortgage, 4) the monthly payment on other loans, 5) the monthly payment for mortgage-related obligations, 6) current debt obligations, alimony, and child support, 7) the monthly debt-to-income ratio or residual income, and 8) credit history.

It is hard to understand the logic behind an ability-to-pay rule. Perhaps borrowers lack the mental capacity to determine whether they will be able to make mortgage payments. Lenders, however, should be able to make that determination. Banks do not make money by making loans that are not repaid. They have every incentive to make sure loans are repaid. Furthermore, they have experience and expertise in determining the

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48. 12 C.F.R. § 1026.43(c)(2).
52. 12 C.F.R. § 1026.43(c)(2).
likelihood that loans will be repaid. So, the ability-to-pay rule seems likely to create extra paperwork and an extra regulatory burden on lenders. It may also prevent banks from making loans to customers who they expect to be able to repay but do not meet the one-size-fits-all criteria established by the CFPB.

THE CFPB AND CONSUMER BANKING

Even without its paternalism and its regulatory discretion, the CFPB can be expected to impose significant costs on the banking sector. Financial firms with total assets of more than $10 billion will undergo annual examinations by the CFPB. Version 2 of the CFPB Examination manual (October, 2012) is 924 pages long. There are a number of other manuals covering specific aspects of the examination. Financial institutions with less than $10 billion in assets are exempt from examination, but not from other rules. Among other things, they, like larger institutions, are subject to Section 1026 of Dodd-Frank which authorizes the CFPB to ‘require reports . . . as necessary’ to support its mission.

The CFPB’s regulation by discretion rather than rules is likely to impose additional costs on the banking sector. Recently, Jim Purcell, President of the State National Bank of Big Spring Texas complained,

Dodd-Frank imposes immense regulatory costs upon community banks, costs that are exacerbated by the CFPB’s persistently, inherently regulatory uncertainty.” “As the CFPB’s own web site shows, its rulemakings are the subject of constant significant revision – and that’s when the CFPB bothers with express rulemakings at all, instead of regulating informally through case-by-case ‘guidance’ and enforcement proceedings.

Finally, the CFPB’s paternalistic approach to regulation will make it harder for financial institutions to offer nonstandard or complex financial products. Marsh and Norman contend that,

A recurring theme in Dodd-Frank, particularly with respect to the

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Consumer Financial Protection Bureau, is that standardization of financial products and forms will protect consumers. This is implicitly a reaction to the narrative that one of the causes of the financial crisis was the inability of parties to understand and appreciate the risks of innovative financial products. But the focus on standardization of consumer financial products, like home loans and checking accounts, fails to recognize the value to consumers of the community banking model, which emphasizes relationship banking, personalized underwriting, and customization of financial products to meet the specific needs of customers and communities.\footnote{Witkowski, \textit{supra} note 36, at 39.}

Yogi Berra is alleged to have said, “Prediction is difficult. Especially when it concerns the future.”\footnote{Esomar, “It’s Hard to Make Predictions, Especially About The Future”, RW Connect (June 10, 2014) \url{https://rwconnect.esomar.org/its-hard-to-make-predictions-especially-about-the-future/}} The CFPB is relatively new and its impact on the financial sector is difficult to predict. It may well be successful in reducing the frequency of poor financial decisions by consumers. But that will come at a cost. Its paternalism and its discretionary enforcement is likely to eliminate financial product and services that are useful and appropriate for some individuals. It is likely to slow financial innovation. It will also impose large compliance costs on banks and other financial institutions, costs that smaller institutions may find difficult to bear.