AMERICAN PREDATORY LENDING AND THE GLOBAL FINANCIAL CRISIS

ORAL HISTORY PROJECT

Interview with

Eric Stein

PREFACE

The following Oral History is the result of a recorded interview with Eric Stein, conducted by Andrew O'Shaughnessy on June 23, 2020. This interview is part of the Bass Connections American Predatory Lending and the Global Financial Crisis Project.

Readers are asked to bear in mind that they are reading a transcript of spoken word, rather than written prose. The transcript has been reviewed and approved by the interviewee.

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Andrew O'Shaughnessy: So, in the first part of this interview, we had just gotten to the point where you went to work for Michael Barr at Treasury [Department] with Tom Scanlon, and you had explained the core concept of the CFPB [Consumer Financial Protection Bureau] as understood at that point. What happened next?

Eric Stein: So I went to work at Treasury and the work they were engaged in when I arrived was writing the White Paper on Financial Reform, which is published. I'm sure it's accessible probably on the Treasury's website. That had a chapter on the different topics that ended up being covered by the bill [Dodd-Frank], and one of them was consumer protection, which included mortgage protection, which [were] the two large parts of the bill that I was responsible for from the administration's perspective. And so, the initial thing was trying to conceive of what CFPB might look like and what mortgage reforms we might want to implement. That chapter ended up being twenty pages or so— there's a lot of writing and rewriting. And while this was going on, there was a White House process where every morning the Treasury-White House working group on financial reform would get together and make decisions on administration policy and what to propose.

Those meetings started before the White Paper. I got there as they were still going and figuring out the White Paper. And then of course, a lot of things weren't covered by the White Paper. The meetings continued as the legislation was developed, and the administration basically submitted the first draft of each of the chapters of the bill. I'm not sure if that's always the case, but we pretty much held the pen on the CFPB element. Obviously, it's Congress' bill, but we had the resources and what we decided through that joint process with the White House and then separately through the Treasury: it's only big decisions that would go there [to the White House] and will be reflected in the legislation. That then in my case, I'd be working with Tom Scanlon, our lawyer, and we had a small team of people that we hired over time to help me, and all of us were lawyers. We would do some drafting, but he was by far the best at it. And so, we would vet different issues.

I can talk about a couple early examples—one issue was mandatory arbitration. When I arrived, the administration had tentatively decided that it's not a bad thing, that there were problems with litigation, and courts are backlogged. It's not a great forum for resolving disputes necessarily. And mandatory arbitration potentially has the ability to do things cheaper and quicker. And so, there was a little bit of sympathy for that view. And then, if you were presenting on a particular issue, if you wanted the group to come to a decision, then you write what's called a "note." So, I mentioned to Michael [that] this mandatory arbitration stuff, it's not what it's cracked up to be. It's really kind of abusive to consumers. He said, "Well, write a note, and we'll talk about it tomorrow."

I reached out to people I knew that worked on it and got all the law review and other articles that I could get on it and wrote a one- or two-page note, probably close to an all-nighter, and then [we] met. And I can't remember the exact statistics, but the consumer lost in 99.5% of the cases. Oftentimes you had to travel to a location that was intentionally selected that was far away, and you had to pay your own expenses. And the person deciding did not have to follow precedent. And the decision didn't provide any precedent, oftentimes didn't write a reasoned opinion, would just come to a decision, even if it got to that point. The deck was just entirely stacked against the consumer. And so, I argued that mandatory arbitration should not be permitted in consumer financial contracts, and I assembled a fair amount of good data. I mean, it's a very data driven process with impressive people. And I said, "You know, there's nothing wrong with the consumer, after there's a dispute with the company, agreeing that, well, I'd like to resolve this through arbitration."

That's not mandatory arbitration, that's voluntary arbitration that happens later as opposed to something that you sign upfront. And I had the experience at Self-Help where we convinced Fannie Mae and Freddie Mac and then the other large lenders to voluntarily get rid of mandatory arbitration for mortgage agreements, because it was an egregious practice that the Associates [First Capital Corporation], I think I've mentioned this, our poster child of predatory lenders, they engaged in. We pretty much convinced the mortgage industry to forgo mandatory arbitration for mortgages. I said the same principle applies to other consumer financial contracts, and we had a discussion about it.

People asked for more information. I think people were largely persuaded, but what we decided was to let CFPB, in the case of consumer financial products—and the SEC, for investor protection, which was another area that I was responsible for the administration, not for Congress— to say, “You can't do them.” Partly because politically, that was going to be hard to get passed, and partly that people appreciated the research that I had done, but it clearly wasn't the end. And so, what we agreed was, we would tell CFPB and the SEC, study mandatory arbitration and consumer contracts, and if you find that they're abusive, you have the authorization to outlaw them, which struck people as fair. And it was a lot better than just supporting mandatory arbitration. So, I was pretty happy about that.

We drafted it up for the bill, and it ended up being part of the final CFPB Act. Also, for the SEC . . . , and I've talked to the SEC, and they agreed that it was abusive and that if they were given the authority, they would get rid of it. They would study it and assuming they learned what they expected to learn, get rid of it. CFPB ended up doing very extensive, impressive hundreds of pages of study, just showing, in my view, beyond a reasonable shadow of a doubt that it's abusive. And they, ban[ned] it as the statute very clearly allowed them to do, that, in fact, told them to do if they found that it was abusive. SEC, I don't think, ever went forward on it. People I spoke to wanted to, but it didn't end up happening. And then, Congress—you're familiar with the Congressional Review Act, which has happened very few times in American history until recently with

the House and Senate both in Republican control. If both houses of Congress vote to overturn a rule, that rule can't go forward. In fact, the agency can't go forward with another rule on the same topic. And Congress overruled that mandatory arbitration ban. So, it doesn't have a great ending. That was no fault of the Treasury-White House process nor of the CFPB after it was established. So that was one example.

Another example was preemption, and we could talk about preemption if you like. Preemption is when the federal government tells the states, "It doesn't matter what you say, our rule applies, and here's our rule." I'd had a lot of experience with preemption as we tried to pass the North Carolina [predatory mortgage lending] bill and other state bills about what can states pass laws on and what can't they. One obstacle, I think I mentioned it last time, was the Parity Act [Alternative Mortgage Transaction Parity Act], which basically said that states cannot outlaw adjustable-rate mortgages. And for depositories, that's one thing where there's a federal regulator, and they're pretty closely overseen. But for non-depository lenders, they're regulated at the state level and really not very closely. An aspect of the Parity Act let the Office of Thrift Supervision say what among these non-depositories, what they're doing with a nontraditional mortgage, which includes an ARM [adjustable-rate mortgage], and the OTS had said that non-depositories can charge prepayment penalties, even if a state doesn't want them to.

We had strongly believed— and I do— that prepayment penalties are abusive, particularly for subprime loans where you have too high of an interest rate, and then you can't even get out of that without losing a lot of your equity. It's an incentive for the lenders to provide adjustable-rate mortgages, which don't work great for low-income families because they need a predictable income stream. So, it's like a double whammy. And before all this happened, I did write a memo that persuaded the [President] Bush Head of the Office of Thrift Supervision, that they shouldn't have done that. That it's one thing for them to promote preemption for their thrifts, savings and loans, but they shouldn't be carrying the water for these non-depositories that are doing bad things.

Based on the memo that I wrote, they actually withdrew that rule, which was great. But it told me the power of preemption and how that's potentially a real problem. And there are several possible types of preemption that could occur. One is when CFPB writes a rule on something, then should that and does that preempt state laws or not. And the assumption, when I got there, most of the working group were people who mostly had worked at the federal level, and it makes sense that you have a level playing field for all states in the country, and [with] CFPB, we're going to invest all this power and authority and resources, that they're going to do a good job establishing the right rule, and that should just apply - we're one country. And there weren't any final decisions, but that was kind of the assumption.

My experience was, we may not have the CFPB we'd like at certain times. And at times when the CFPB is falling down on the job, then states should be able to

pass laws that aren't otherwise preempted, that go beyond what the CFPB wants. How we labeled this was a floor, not a ceiling in terms of consumer protection. And the reality is, if the CFPB instates a strong enough rule, then states aren't going to go through the trouble of trying to pass a law that goes beyond it. But if they do, and if there's a problem in a particular state, then that's a political issue for that state. And potentially pressure can be brought to bear to relax something if it really does go too far. But we're a Federalist system. States are a laboratory of democracy. CFPB rules should not be preemptive.

The second question was, what about state attorneys general? Should they be able to enforce the CFPB Act or should it just be the CFPB? And again, my perspective was, CFPB is not always going to be aggressive in enforcing even the laws that are on the books or the rules that it had previously [issued]. And allowing state attorneys general to bring lawsuits under the CFPB Act would be a good check on the CFPB going dormant for a period of time.

People were persuaded by that, which, since the Trump administration installed the heads of the CFPB, the number of enforcement actions are way, way down, and a lot of the strong rules are in the process of being repealed, like against payday lending. And so, there are some strong attorney generals that are bringing lawsuits like in Pennsylvania [and] North Carolina. And so, people were persuaded and that ended up being a big fight all the way through as to how much preemption there would be.

An even bigger fight was over the somewhat separate issue than CFPB, which is the National Bank Act preemptions. How broad should that preemption be? The Office of the Comptroller of the Currency had really aggressively extended the preemption accorded to national banks. And no one disputed that national banks get a certain amount of preemption, but it's a question of how much, and we wanted to reverse some of the really extreme ones. For example, you have a bank and then they have a non-bank subsidiary. Under the OCC's [Office of the Comptroller of the Currency] rules, called the Watters case [Watters v. Wachovia Bank, N.A.], the non-bank subsidiary should be accorded preemption, but it's not a bank.

If you're doing something in there that needs preemption, that should be done by the bank, then it's going to be supervised by a federal bank regulator, and we have some confidence that bad things won't happen. And so, we tried to roll back federal national bank preemption, and that ended up being a massively controversial enterprise. I was responsible for the administration on that preemption piece. And it ended up actually closing down the House of Representatives to all business, as the House was finally considering passage of Dodd Frank, because the Blue Dog Democrats— who are a group of moderate Democrats— they wanted national bank preemption. Unless they cut a deal with us, the administration, on preemption, and they were satisfied with that aspect, then they were going to vote against Dodd-Frank, which would mean that Dodd-Frank wouldn't have enough votes to pass the House. And so, we showed up to the Capitol and Melissa Bean, who is from Chicago, she ended up

losing the next time, but she was the head of the Blue Dog Democrats, or at least on the preemption issue. They called us in and said, "You need to come in and negotiate on preemption, or Dodd Frank is not going to pass and the bill is not going to go forward."

We showed up, and it was Neal Wolin, who was the Deputy Secretary at Treasury, and my boss, Michael Barr, who reported to Neal, and then me, who reported to Michael, and I was [the] subject matter expert. Both of them were somewhat familiar with it, but not as much as me. And we come in, and they give us a twenty-page bill that the bankers had written and said, "This is our proposal." And preemption is so technical. Like the difference between one word versus another, that could be a work of art, is the difference between it being widely preemptive or not. I mean, it wasn't conducive for thoughtful analysis, showing up and then read it now and then we'll negotiate, and only if we get there will the bill pass. And fortunately, Neal and Michael are both just brilliant people and much faster at being able to absorb information [than I am]. So, we huddled and talked about it, and I told them what I thought about it. And they were familiar too, and we talked about it, and we just didn't have long to do that. And then we negotiated, and I mean it probably took an hour or maybe two. And then we couldn't come to an agreement, and it ended up between Neal and Representative Bean, one-on-one, negotiating over the final words.

And they came to a compromise wording that certainly didn't come from me. It was a compromise that ended up being pretty good. But both sides were satisfied with it, and the bill got a check mark from the Blue Dog Democrats and ended up passing the House. But that was another issue that we spent a lot of time talking about, is how much preemption should there be for national banks and how should that be described? There were several other issues that I'm not thinking of.

But anyhow, it was an impressive group. I mean it's intimidating, starting out with— Cass Sunstein, who people talked about for the Supreme Court and was the head of the OIRA [Office of Information and Regulatory Affairs] at OMB [Office of Management and Budget], and this guy Alan Krueger, who's an economist at the Treasury who was talked about for the Nobel Prize. It was a collegial, nice, impressive group, and I felt like we came to good decisions when there were ones to be made on what the contours [of the] legislation should look like.

Andrew O'Shaughnessy: … It sounds like most of what you would want in the realm of pure logic and abstraction made it at least as far as the White Paper stage. Is that fair or did things get left on the cutting room floor?

Eric Stein: No. So, the White Paper wasn't that detailed. It was really more of a question of what was in the legislation. I can't remember if we talked about mandatory arbitration in the White Paper, for example. There are compromises made in the House that cut back on what the White Paper said. A number of them were actually good policy. For example, the idea was that the CFPB would examine

banks, as well as non-banks, for compliance with consumer financial protection laws, and not the safety and soundness regulators because they're so focused on safety and soundness, and the CFPB will become expert in compliance. But the community banks hated that idea of the CFPB coming in. And there was a compromise early on by Brad Miller, who was one of the early sponsors of the CFPB Act, he's from North Carolina, which was that the CFPB would only supervise the larger banks, over ten billion [dollars in assets], and that the safety and soundness regulators would be the ones responsible for the smaller banks.

And that was a bit of a battle, but in actuality, it would have been really hard for the CFPB to staff up to supervise these small banks that aren't a large percentage of the assets of the banking system. And it would cause a lot of friction, and this was just better for the world. So that was a compromise that I think was helpful. Another, along the same lines, is that the CFPB was also going to be supervising non-banks. And that was one of the selling points to the banking system, is that if you don't have a regulator looking at both of you, then the lowest common denominator is the non-banks, and you have to compete with them, and you may not be able to. And if you do, then you may be forced to do things you don't want to do. But of course, non-banks, who haven't been federally regulated, they don't have any interest in that, particularly the smaller ones. And so, we had another compromise, which was the CFPB would only supervise the “larger participants” of the other consumer financial markets. But there were certain exceptions, which ended up being mortgage lenders, everybody recognized that mortgage lenders need a lot of supervision, and unregulated brokers were a lot of the problem before the crisis.

A late one that we got agreement for was all payday lenders could be supervised, and credit reporting depositories, because they're so large, they could be supervised. And then beyond that, the CFPB would have to look at a particular market and write a rule and identify what entities it would be able to supervise by definition. Sort of like the 80/20 rule, in actuality, that if you just look at 20% of the entities, that's 80% of the activities, and it's a lot more bang for the buck for a federal regulator. So that was a compromise too, but I actually think a pretty good one because it doesn't make sense for the CFPB to spend all this time with tiny, tiny entities all over the country. It'd be spread too thin.

There was a big fight over car dealers, that there's the problem of yield spread premiums with mortgages where originators, often mortgage brokers, but also lenders, would get a higher payment, the worse terms of the loan they put the borrower in. So, they get $1 if they put the borrower in a 5% loan, but $2 if they put them in a 7% loan. The incentives are directly reverse. They're following their incentives, but their incentives are to please who they're selling the loan to, not to the borrower. And it's just misaligned incentives. And so, in the mortgage provision, we put in a provision that the originator’s compensation can't vary based on the terms of the loan to get rid of this steering into worse loans because you get more money.

And that was rampant during the crisis— I mentioned Countrywide where they could earn three-and-a-half percentage points for a subprime loan that was no doc [no documentation] and one percentage point if that same borrower qualified for a conventional loan that's much better for the borrower. Of course, they're going to steer them into a worse loan.

The same is true of car dealers. There have been a lot of studies that there are racial disparities in car loans. If you go into a car dealer and they're the one who gives you the loan, they're not actually lending you the money, they're acting as a broker to a bank or to some other entity who's lending the money. They're assigning the contract to that other entity. And how much they get paid is generally dependent on the interest rate on the loan. The higher the interest rate, the more that dealer gets. Again, the incentives are just bad, and we wanted the CFPB to crack down on that. It's called dealer markups. CRL [Center for Responsible Lending] has put out a lot of papers on that problem. And [car dealers are] a fierce lobby, and it was a really big battle over whether the CFPB would have jurisdiction over them. This was one of the ones that we lost, that we were sorry that we lost, but it was a compromise at the very end on the floor of the House. As they were headed towards passage, they pulled me aside, in Representative Frank's office, and said, "You're not going to want to hear this, but we're going to have to exempt car dealers to get this bill passed." So that was a loss. We did get in there that the FTC [Federal Trade Commission] could write a rule and deal with that problem. So, the FTC has the authority. For most rules, the FTC can't really write rules. They have a very elaborate process that takes several years.

But for this one, that would just be a regular rule. The FTC hasn't used that authority. They have it. The CFPB ended up getting at that same problem— now this is another one without a happy ending— by going after the banks that were the ones buying the contracts from the dealers and saying, "You can't do that if you're paying more for higher interest rate loans." And they had enforcement actions against banks, and that was very controversial. And if I'm remembering correctly, I think there was another Congressional Review Act that overturned those actions by the CFPB so that the FTC could still come and address the problem, but they haven't done it. So that was a compromise that we definitely did not like.

Another thing that we were pushing initially was strengthening the Community Reinvestment Act. But Chairman Frank early on says, "That's just a nonstarter, it's too controversial." And so, we dropped that. That was in our White Paper, but we never put in legislation because he said it wouldn't pass, and he didn't support it.

I actually think that was a wise move. It is complicated. It's continued to be a political football. The OCC recently put out a really bad rule that totally weakens the existing, already somewhat outdated Community Reinvestment Act. So that was another compromise that I think was a reasonable one. But the bill that became law ended up actually with almost all the authorities that we wanted in

it. And it was kind of shocking. As it left the House, I have to say there were a lot of exemptions for particular industries, and the funding was very convoluted and I don't think really would have worked. What we encountered in the House was that there was generally a representative that had a home district interest that wanted an exemption from the bill.

They would oftentimes to push for that. And to get the bill passed, it was felt there was a need to accommodate that member. And what we had always thought was the House was a more liberal place than the Senate. It was a larger majority, and so the House was going to be the high watermark and anything [would be] weakened at the Senate. And what left the House— I actually wasn't very happy about the CFPB provisions because there were so many exemptions and the funding didn't really work. But once we got to the Senate, I think it's just because Senators have a bigger scope of authority and more things to worry about, they didn't push as many single industry exemptions and [we] were able to clean out a lot of the things like where you have a rule, and then you have an exemption, and then try and clean it up, and then you have something else that ends up with lack of clarity or lack of coverage. And there were quite a number of examples, and it was partly that Senator Dodd and their staff were just very effective. But I think it was more that they didn't need to do it. I mean, Representative Frank would have preferred that these exemptions not be there, but it's just the part of the House process. But we were able to clean them out.

And so, the final CFPB Act bill coming from the Senate, and that was used as the basis for conference— it ended up being a conference between the House and the Senate, but the base text came from the Senate— had virtually all the authorities and powers that we wanted. The funding was very important. We felt that if funding was reliant on appropriations from Congress, that those exemptions that we saw that actually came to pass in that bill that passed the House would reappear or even more so with riders to appropriations bills when it's being appropriated for the CFPB.

And they would say, for example, "You can't spend any money trying to regulate payday lenders." They would just say that. And then you're stuck. And well, we ended up with the Senate, which was surprising that we could, but it was essential for the CFPB to be effective. The CFPB is actually officially part of the Federal Reserve Board. However, it's fully independent, but it gets its funding from the Federal Reserve Board. And so, from appearances, it's part of the Federal Reserve. And so of course, it's going to get its funding from the Federal Reserve, but what that does is it frees it from the congressional appropriations process that was going to— anytime it did anything— find that it couldn't do whatever that was. No question. The House bill had it assessing the non-banks for money and assessing the banks, but that was going to be a continuing problem because people are going to fight again about that, and you're not going to be able to raise money. I mean, it was going to be a battle to raise money, and that money, even if it raised it, could still be subject to conditions from Congress. So, it wasn't going to work, but we got this independent funding and there's one anecdote where towards the end, it looked like that might get

revoked because the Appropriations Committee Chairs, Democratic or Republican, were not happy with that, because everybody wants to be free of congressional appropriations.

But the authority of the Appropriations Committee is exactly that, and they liked that authority. And that had to be accommodated in the House and the Senate. It looked like it may have to be accommodated as well, in which case we lose the independent funding. I worried that would mean that we lose a potentially effective CFPB. And I remember having a conversation with a senior person at the Treasury about that and there being skepticism that we'd be able to maintain that independent funding. But we were, which was great. And a lot of that was due to the skill of the Dodd team, in Dodd pushing for it. And we came up with it. So the bill really ended up where we wanted it.

There was an issue about whether there should be a commission or whether there should be a single director. I don't know if you saw the Supreme Court case that came out this week. We want it to be an independent agency, so it's not subject to pressure from the administration. And we worried about having a commission. We went back and forth. The White Paper actually had it to be a commission initially, but by the time it got to the Senate, we were persuaded it should be a single person. Because at that point, the Republicans just weren't confirming nominees, there were many agencies that didn't have a quorum, and it's not like places with commissions don't have big swings, which is the issue with the single person. They can have them as well. And we thought that there's not going to be the potential for an effective CFPB if you're [not] independent. Because then you have to get three people who are going to do what you want, and the odds of getting one, like Richard Cordray, aren't necessarily that high. But to get two - but to get three - and to maintain that and assume that the Senate is going to confirm them - I think it wasn't that realistic. If you look at other agencies that have multiple members that work in very controversial areas, they're oftentimes just not able to do anything. So, we got the single person. What the Supreme Court said was the structure is too removed from the president in terms of that the president could only fire them for cause.

And so, the Supreme Court struck that provision and said, "No, the president needs to be able to remove you for whatever reason." And the good news there is it said that because of the severability provision that we had put in the Dodd-Frank Act, that doesn't invalidate the rest of the CFPB. The rest of the CFPB can go forward, but there's probably going to be more frequent changes of the director, which is unfortunate in the long-term. In the shorter term, there could be a new president and there could be a new director coming up shortly.

We had actually copied the structure from the Federal Housing Finance Agency, which is the conservator of Fannie Mae and Freddie Mac and until last January, I was there for five years as a senior advisor to the Director. That was a bipartisan bill with Shelby and Dodd that was passed in 2008 that established FHFA [Federal Housing Finance Agency], which is in HERA [Housing and Economic Recovery Act of 2008]. Everybody recognized that financial regulatory agencies

are supposed to be independent, like the Federal Reserve, the OCC, and nobody thought that there's a distinction between a commission and a single director on that. Five members of the Supreme Court felt like that was a distinction worth making, but I don't think it's the end of the world.

Andrew O'Shaughnessy: Well, so I'm curious, [in] our oral history interviews, in addition to the policy details, which are of course very important, we'd like to get a sense of what the individual we're talking to experienced… What was it like?

Eric Stein: It was very difficult from a personal perspective. I was commuting back and forth each week. And I was just working. Like when I wasn't asleep, I was working, [when] I was in DC, and also when I was home. So even when I was home, I wasn't seeing my family much, wasn't eating a lot. There was a lot of pressure because there was a real chance that whatever provision I was working on, whatever language I was working on, there's a real significant chance that that would become law. And when something becomes law, it's very hard to change. Very little of Dodd-Frank has been overturned since, even when there was a Republican House, Senate and presidency, because it's hard to change the law, and not many laws get passed.

And so the pressure of trying to figure out what the right answer is from a policy perspective and then trying to work with our lawyers and get the right words on the page that would achieve that policy perspective, and to then try to work with the congressional sponsors and try to see that that gets passed or something that does the same thing, to try to get allies to support it, try to fight off amendments that are intentionally trying to weaken it or get exemptions from it, and end up with something that can be passed. Because [for] a lot of Democrats, the most important part of Dodd-Frank was the CFPB Act. And without that, it's not clear that they would have supported it. On the other hand, a lot of Republicans hated it.

A lot of industry players hated it. And a lot of external pressure as well. The Americans for Prosperity, [which is] a Koch Brothers funded group, did a demonstration at CRL against me saying, "Stein must resign" because they said I was in line to become the permanent head of CFPB if it passed, which I don't think I was ever seriously considered for. But since I was the lead person in the administration, I guess they just thought it would be me. I don't know. And they put two full page ads in Politico, like color ads attacking me and previous work I'd done at CRL. And the Chamber of Commerce was— I mean, it was internal and external, and just feeling the pressure to get it right so things don't get screwed up— an incredible opportunity to be able to try and do my part there. But, from a personal perspective, it wasn't a happy time, but I'm very happy as to how it ended up. It took a year from start to finish, from when we gave our first discussion draft to Chairman Frank, and then discussion drafts would come out, and then people would provide comments to it generally saying, "Here's a technical fix," which is an exemption for me in my industry.

But often times it's such complicated stuff that it would catch drafting errors that were inadvertent. And it would happen a lot. We get discussion drafts—and there were a just number of drafts that are somewhere on the internet, all the different drafts. And then there'd be committee markups where amendments would get considered. And some would be things that we had a hand in, some would be things where we'd help write talking points as to why the amendments would be a bad idea. And that was always a worrying prospect, what happens in committee and the number of votes along the way. Then ultimately it went to the House floor, and then it went to the Senate Banking [United States Senate Committee on Banking, Housing, and Urban Affairs]. And I do remember this, there was going to be a markup in Senate Banking, and we were very worried about what was going to happen there because the Democrats didn't have that much room for maneuver. And there's a lot of industry opposition, and there were a lot of Republican amendments that had been filed. And we basically pulled two all-nighters writing talking points to help prepare the Senators when these were being considered.

And this was when the NCAA [basketball] tournament was going on. And what was happening was that the Senate staff, Republican staff, were watching the NCAA tournament and they weren't doing the preparation that we were doing. And we got to the committee hearing, and we were ready and nervous, and we show up and then Senator Shelby says, "We won't be offering any amendments." And so, there was just a vote on the bill, which passed on a party line vote. Because the Republicans didn't feel that they were really ready to argue about it. And that was their main opportunity to get changes. It was just astonishing that that's what happened, but anyhow, so then it got to the Senate. But then there were amendments on the Senate floor, which was another terrifying period because there's some amendments that sound reasonable that could just destroy the possibility of regulation [altogether], and it wasn't clear whether they're going to pass or not.

Andrew O'Shaughnessy: What was an example of that?

Eric Stein: Yeah, I wish I could remember. There's one in particular. I don't know. The friend I worked on [it] with is now Mayor of Hartford. I could ask him if he remembers. It sounded so reasonable that an agency can't issue a rule if— I mean, the effect was if it harmed any business - of course, any rule is going to harm a business - it was written in a very clever way. And I was just terrified it was going to pass. And not only are we going to hamstring the CFPB from doing anything, but it was something that would apply in all cases. It's like, there's no more regulation in the world. And that was quite terrifying. It was beat back, but it wasn't clear that all of these things where you can get beat back, but they were. No really damaging Senate amendment on the floor passed. But every time the Democrats offered an amendment, the Republicans were permitted to offer an amendment. And I remember Senator Dodd's staff person, Jonathan Miller, say "We've got to stop these Democratic amendments because one of these showstopper Republican ones are going to pass!" But they didn't.

And [the bill] passed the Senate, and then it went to conference. Conference almost never happens now. Usually it'll ping pong back and forth until one chamber will ultimately just agree to the version that the previous other chamber passed. I'm not actually positive— maybe because the House and Senate bills were so different and it's such a consequential piece of legislation— but the conference process actually went very well. The way it works is the conferees adopt a base text. And the base text for Dodd-Frank— for all the chapters— was the Senate bill, which as I mentioned, I really think was cleaner, certainly the part that I was working on. But the mortgage bill [Mortgage Reform and Anti-Predatory Lending Act of 2009], we had a Senate companion, was the House version that had been passed in the previous sessions, and Mel Watt and Brad Miller were the two primary sponsors of that.

Mel Watt is the person that I worked for at FHFA. He was the director of FHFA [Federal Housing Administration] until last January. And I felt as though there were a number of issues with the House mortgage bill that really should be addressed. Some were exemptions that just happened as a result of the House process that needed to be cleaned out for it to be effective. It wasn't strong enough, but in other ways, I felt like it [went] too far. It would affect reasonable, responsible mortgage lending. And so, we worked with the Senate staff person and Frank's staff, and everybody ended up agreeing to certain changes to it. But it was a little bit harder because both chambers would have to agree to any change. And the House sponsors, the gatekeepers, would have to agree to any change. But it was a collaborative process, and it ended well. I think industry would largely agree that it doesn't interfere with conventional responsible mortgage lending but provides some really great protections that have not been rolled back since.

Digressing on that for a moment, I'd mentioned the paper I wrote in 2001 that talked about the cost of predatory lending. It identified loan term provisions that we felt like were abusive in the case of a mortgage borrower who doesn't really understand the options available to them and a much more knowledgeable mortgage lender where the originator has a financial incentive to put them in the worst loan that they can. And so, the provisions of the mortgage bill that ended up being included addressed the loan term issues that were in that paper and that were in the North Carolina bill and [we] learned about from other state bills and those policy issues. I mentioned that loan originators can't get paid more by putting the borrower in a worse loan, that's in the law; that you can't have prepayment penalties for subprime loans, that's in the law; that you can't have no documentation lending. Because a lot of what happened during the crisis is, the broker would fill out an application inflating the borrower's income and getting them a loan that they couldn't afford from day one because there was no requirement to document that that income is actually there, so no doc lending is prohibited.

There was a lot of not escrowing for taxes and insurance. It was an opportunity for flipping, because the borrower would need to come up with a large lump sum to pay the homeowners insurance or the property taxes, which they

haven't necessarily saved for. That's when servicers escrow forward and spread that payment over the course of the year, and so, instead include the charge just in your regular monthly mortgage payments. So, we required that mortgage loans be escrowed for taxes and insurance for subprime loans, for loans above a certain price. That was a protection that's in the bill that was an abuse during the crisis.

The upfront fees were potentially too high. And so upfront fees are limited to five percentage points. And there was an ARM, adjustable-rate mortgage, underwriting protection has to be underwritten at the fully indexed rate, not at the teaser rate. And then there was a requirement put on the lender— and this was from the mortgage bill before we worked on it, which was a great work by the House and the sponsors and Chairman Frank— was that a lender is required, it's commonsensical, to make a good faith determination that the borrower can reasonably afford the mortgage loan at origination. And that requirement that there is an ability of the borrower to repay the mortgage loan was not the case before.

I mentioned that the abuses that we discovered early on were legal, and giving someone a loan they can't afford was legal. But that's a subjective finding that lenders would worry about [on] a case-by-case determination as to whether the borrower could meet it. And so, we established something called the qualified mortgage. Again, this was in the previous House bill, and qualified mortgage would have further protections. If a lender provided those protections, then they would be presumed to have met the ability to repay requirements.

So, it's a litigation incentive for them to provide even better protections, and the protections are that it has to be an amortizing thirty-year mortgage. It can't be interest-only or negatively amortizing or a balloon [mortgage]. It's just a vanilla loan, such as middle-class people have always gotten. The subprime loans were not that, and the Alt-A loans were not that. I mentioned that over half of mortgage loans during the boom that African Americans received were subprime loans that were not that. Secondly, they have to underwrite ARMs, at the maximum possible rate for the first five years. So, you couldn't have the exploding ARM loans. And thirdly, the allowable points and fees were three percentage points, not five, excluding legitimate third-party fees. And the structure of that mortgage bill, the CFPB then issued regulations implementing it.

And when I got back to Self-Help, I thought I was done with federal advocacy and I was going to do commercial revitalization work, maybe similar to what you did in New York City and in Durham, which would be very tangible. But as the CFPB struggled to figure out how to write rules implementing all these different provisions, I ended up getting drawn back in— because I had strong views as to what they should be— to helping try to convince the CFPB to write reasonable rules that didn't choke off legitimate access to credit and implemented these protections in a balanced way. So, I end up spending the next couple years writing comment letters and working with other sources all to try to provide the

same message on the different rules that the CFPB ended up having to . . .issue. And I actually think that the way the law came out and the way those rules came out, I think mortgage lenders and consumer groups would largely agree that it ended up in a good spot, I have to say. And I've been spending a lot of my time, since I've been back this second time to Self-Help, because the CFPB is having to rewrite the rule on the "qualified mortgage" because the first one sunset after seven years. The way that the CFPB dealt with it before, which is to say if a loan was eligible for purchase by Fannie Mae and Freddie Mac in addition to having these product restrictions that I mentioned, then it would be considered a qualified mortgage.

That was a temporary thing that only lasts for seven years. So, I've been spending my time working with consumer and civil rights groups and industry to try to provide a common suggestion to the CFPB on how to define "qualified mortgage" this time so it will continue to work. And the CFPB just put out a proposed rule that actually implemented exactly what we proposed. In fact, we were the only one to propose exactly what they proposed in their proposed rule. There's still a question as to what the price of the loan will be. So we'll still comment. We want it— they want it exactly as they proposed it. But what I've discovered is once you start on this work, it never ends, but anyway, that's a digression. I'm not sure exactly where we are.

Andrew O'Shaughnessy: …How do you think that this huge raft of changes has stood the test of time so far?

Eric Stein: In mortgage lending, I would say quite well, in my opinion. The CFPB, as an institution, I think quite well. I mean, I can't remember how many billions of dollars in restitution borrowers received as a result of enforcement actions under Director Cordray. And I think they wrote very good rules that would protect from a lot of abuses. And the structure is there for that to happen again. There's been a period where it hasn't been, as tools haven't been fully used. So, I think the structure has— test of time— has passed that test. The issue of the removability of the Director is going to be different. And so, we'll have to see how that works out in practice. Another provision I worked on had to do with investor protection. It gave the SEC— this was negotiated at the very end— the authority to tell people selling investment products that they would have a fiduciary duty to those people. And so again, they wouldn't have the incentive to put someone in a worse investment product because they no longer got compensated more for that. For example, one that's sponsored by their company as opposed to by another company if they also covered that other company's stuff. SEC has not implemented that.

The Obama Administration, the Department of Labor, had a similar set of authorities, which they called the Fiduciary Duty Rule [DOL Fiduciary Rule], that got to the exact same issue that was also overturned by the Congressional Review Act. But the SEC has the authority, so that wouldn't have been overturned. So potentially the SEC could still do something on that. That authority has stood the test of time because if there's so much evidence of

people paying inflated fees because it compensated their investment broker more. [It should have provided] the same fiduciary duty that investment advisors have to investment brokers, most of what this would have been done with that investor protection provision that I've worked on.

So, all financial reform is a work-in-progress. Nobody anticipated COVID. That has a new set of challenges. Laws can get weakened. Regulations can get weakened. There's a need to adjust as times change. We put in a requirement that all major rules need to be revisited every five years, so that if times change, then the CFPB will have the information to make adjustments, and qualified mortgages are an example of that where the CFPB is doing a good process to try to come to a -

Andrew O'Shaughnessy: … Is there a legislated basis on which the CFPB has to make determinations about the rules, or is it just that they have to?

Eric Stein: The requirement is that every five years they need to revisit all major rules. I'm not sure if major rules are defined. It may be under the OMB rules there's a definition of that. Anyhow, we wanted the advantage of having things done regulatorily as opposed to legislatively, which was how scared I was. And being involved in drafting legislation is— it's so hard to change that. Of course, regulation is much easier to change. The whole strategy that we had of providing things that we were very confident of and knew, and there were clear abuses like mortgage lending, a lot of those details [we put] in the legislation, but still there's a lot that needs to be done by regulation. There are hundreds of pages of CFPB rules implementing those, but giving an agency the authority to do something when it discovers that it needs to. And the CFPB implemented— they have these market teams for each, like credit cards and short-term lending and mortgages— they have teams that do market assessment and surveillance to know when there are problems, when they should consider doing a rule. So, I think that was a good design advance. Elizabeth Warren and her team did that at the CFPB. I feel good about what came of the Dodd-Frank process on consumer financial regulation.

I have to say, after the bill passed, it passed at like four in the morning, and I can remember being so tired. And there was like an hour period before it ultimately passed that the last amendment that dealt with the CFPB was considered. And so the bill might pass or fail, but I was no longer like on high alert and on call, and so I was able to relax for the first time in a year. And then it ultimately passed. I remember being so tired getting in the metro and sleeping through my stop and having to go back a couple of stops. But then, the bill gave the Treasury the authority, the responsibility to stand up the CFPB. The Treasury would have the CFPB authorities for a while, and then it would go over to the CFPB once a Director was confirmed. And then I was given the job within the Treasury to stand up the CFPB in terms of how it would be organized and to start recruiting staff who would get hired on at the Treasury but would then shift over to the CFPB.

One advantage of that is the pay scale for the CFPB is higher, so that would be an advantage. And I had that job for, I'm not sure how many months, maybe three months or so. And then a day or two, and then Elizabeth Warren was hired for that exact role. She had ended up with a joint White House and Treasury appointment with that job of standing up the CFPB. The difference is that I reported to the Treasury chain of command— to Michael, to Neal, to Tim Geithner— and Elizabeth, the deal that she cut was she had the autonomy to— so the team moved offsite from the Treasury. I mean, we were out of room anyhow. And I reported to her for a while until just after Thanksgiving, when I was done entirely and came back to North Carolina.

Andrew O'Shaughnessy: … Over the course of these interviews, we've heard a few different accounts of the origins of the financial crisis. And so, we just like to ask everyone what their understanding of that narrative is.

Eric Stein: My view as to the origin of the financial crisis is that starting in— primarily really starting when we started seeing the Associates stuff in the late 1990s— but starting in the early 2000s, the development of subprime lending, particularly funded by private-label securities, and Alt-A lending. And the underwriting controls that banks used for their own portfolio lending, and that Fannie Mae and Freddie Mac and FHA used for their lending, were bypassed by a new channel, which is PLS [private-label securities], which are created and funded by Wall Street.

And they're put into pools that are then broken into AAA-rated securities, and then there are the subordinate pieces, which are riskier. And there are no rules on underwriting other than that you get people to buy the securities. And the underwriting just deteriorated drastically. But they kept getting funded by Wall Street. And we only discovered later, one thing that was happening was that Wall Street firms were taking those subordinate pieces that were riskier, through collateralized debt obligations, and putting them into new securities with subordinate pieces. But the senior pieces are actually really risky because they're backed by really risky junior pieces. But you needed to get less money. So, then the junior pieces of the second-order securities are a smaller amount of money that could get covered to fund more subprime loans and Alt-A loans. And those Alt-A and subprime loans, the borrowers had no ability to repay them. They were no doc. The interest rates exploded if you were able to stay in it. The mortgage brokers were incentivized to put you in bad loans. The only way that that structure worked was that house prices were increasing. I discussed this in the 2008 Senate testimony at length with a lot of charts. And if that happens, you can have the worst loan that fails, but you can refinance that borrower because there's equity in the house.

If you continue not to have underwriting standards, the borrower can get a new loan, and the previous loan doesn't get foreclosed on, or the borrower can sell the house because house values are rising. And so, all the underwriting problems were masked as the loans were made and appreciation was going at an unsustainable pace. And the loans would start at a lower interest rate than

the principal balance warranted if it were an amortizing loan. I mentioned the interest-only, and the negatively amortizing, and exploding ARM payments. And so, at some point, the borrowers couldn't pay that loan. They'd have to get a new one. At some point, appreciation wasn't going to rise like that. And what further happened, which nobody knew, including Federal Reserve Bank of Richmond— I was on their advisory board, I think I may have told you that— and unbeknownst to just about anybody, the banks were investing in credit default swaps that bet on the performance of those securities. So not only were they subject to the losses directly on their balance sheet and people invested in those securities, but they were subject to bets on those securities, which drastically increased their exposure, particularly bets on these second-order securities.

And the investment banks were way [over-]leveraged. They had been deregulated under Bush, and the affiliates of investment banks, there weren't leverage requirements for them. Those assets were not applied to their parent, and so they're able to leverage a lot deeper. And eventually, when so many people weren't paying their mortgage, the appreciation stopped, and people couldn't refinance any longer. And the foreclosures started to add up. And there was a foreclosure crisis and the financial institutions, which were so leveraged and so subject to mortgage risks well beyond just the direct foreclosures but also the leverage bets on that, their capital got eaten into, they started getting into financial difficulty. They started clamping down on lending, and a financial crisis then caused a real economic crisis. So, you started having people who had regular, fine mortgages, getting kicked out and becoming unemployed because of the real economy problem.

It started as a foreclosure crisis because of unregulated Wall Street activities, but became an economic crisis that everybody felt - and then the house values started not just leveling off, but declining. And there's a lot of negative equity, then there was a further foreclosure crisis, further economic crisis. And so, the fundamental cause of the crisis was Wall Street’s reckless lending, providing incentives to loan originators to put people on loans they couldn't afford, and financial institutions betting on the performance of those mortgages that were not sustainable…

[END OF SESSION 2]