Monitoring, Reporting, and Recalling Defective Financial Products

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Daniel Schwarcz†

INTRODUCTION

Firms that sell tangible consumer products are obligated to monitor the safety of those products even after they are sold to consumers.1 These companies are also required to report to federal regulators any information they obtain that reasonably supports the conclusion that their products present undue safety risks.2 Finally, manufacturers of tangible consumer products are encouraged—and in some cases, required—to correct potential safety problems through mechanisms such as a product recall.3 These obligations of firms to monitor, report, and correct safety-related product defects that come to light after sale are premised on the fact that many such problems are not fully understood prior to sale.4 At the same time, individual firms are usually better positioned than either the government or consumers to detect these problems.5 By both encouraging and requiring post-sale monitoring, reporting, and correction of product safety

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1 See 15 USC § 2064.
2 See 15 USC § 2064(b)(3). In particular, firms must alert the Consumer Product Safety Commission, which is the agency with authority over recalls of tangible consumer products. See 15 USC §§ 2053, 2064(d).
3 See 15 USC § 2064(d).
4 See Omri Ben-Shahar, Should Products Liability Be Based on Hindsight?, 14 J L Econ & Org 325, 327 (1998) (examining the question “how much of the information which is known ex post but was not available to the manufacturer ex ante should be utilized in determining the reasonableness of the product’s design”).
5 See generally id.
problems, law and regulation may be able to help proactively avoid consumer accidents.\textsuperscript{6}

Unlike firms selling tangible consumer products, firms that sell consumer \textit{financial} products are generally under no obligation to proactively monitor, report, or correct potential problems with their products that manifest themselves after the time of sale. Instead, most consumer financial protections are aimed at regulating sellers’ behavior and product features prior to, or at the point of, sale.\textsuperscript{7} Yet as with tangible consumer products, the risk of consumer harm resulting from the sale of financial products cannot always be accurately gauged until after sale. And as with tangible consumer products, firms are usually comparatively well-positioned to detect potential problems with their financial products. Finally, as with tangible consumer products, there is at least a theoretical possibility that law and regulation may be able to limit the incidence of “financial accidents” by requiring firms to monitor markets for their occurrence, report such events to regulators, and proactively safeguard against their reoccurrence.

To be sure, the analogy between the post-sale obligations of firms that sell tangible consumer goods and those that sell retail financial products is both imperfect and limited. Although the subprime credit crisis demonstrated that financial products can cause devastating harm to consumers,\textsuperscript{8} they obviously cannot directly physically harm consumers as can chainsaws or lawnmowers.\textsuperscript{9} Even more importantly, many of the risks created by retail financial products are important features of, rather than defects in, the product.\textsuperscript{10} Consequently, it would be impractical and unhelpful to simply suggest that financial firms monitor their products on a post-sale basis for “accidents” or “safety problems,” in the same broad way that the law governing tangible consumer products requires.


\textsuperscript{7} See Part II.A.

\textsuperscript{8} See Kathleen C. Engel and Patricia A. McCoy, \textit{The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps} 10 (Oxford 2011).


\textsuperscript{10} See Schwarz, 48 Wm & Mary L Rev at 1453–56 (cited in note 9).
This Article nonetheless considers the possibility that consumer financial protections can profitably draw on the product safety regime to impose post-sale obligations on firms. In doing so, the Article focuses on the expanding obligation of firms to sell financial products suitable to consumers’ needs. This principle of consumer financial protection shares some key features with the law governing product safety: suitability violations can be difficult for firms to detect or police against at the time of sale, even though firms may be relatively well-equipped to identify and mitigate compliance failures on a post-sale basis.

These analytical similarities create the prospect that suitability regimes can be improved by drawing on post-sale product safety principles. The Article illustrates how this approach might work by reconsidering the Consumer Financial Protection Bureau’s (CFPB) rules implementing the Dodd-Frank Act’s “ability to repay” requirement for mortgages. For instance, the Article suggests that these rules could require creditors to assess the accuracy of their ability to repay models using historical data on actual default rates. To the extent that such back-testing revealed substantial deficiencies in the creditor’s underwriting model, the creditor could either be required to report this problem to the CFPB or be incentivized to do so through a limitation on liability or regulatory exposure. Finally, in appropriate cases, the creditor might even be required or encouraged to offer mortgage modifications to consumers who at the time of sale were incorrectly determined to have an ability to repay.

This Article proceeds as follows: Part I describes firms’ post-sale legal obligations and incentives to proactively monitor, report, and correct potential safety problems with their tangible consumer products. It also describes several features of consumer product markets that can be used to justify imposing such post-sale obligations on sellers and manufacturers. Part II argues that these features are also found in certain consumer financial protection settings, focusing on the particular case of suitability rules. Part III then demonstrates how these similarities might be exploited to improve the effectiveness and efficiency of certain consumer financial protection rules, using the CFPB’s recent ability to repay rules as an example. Part IV concludes by suggesting that various consumer financial protection issues other than suitability might also be improved.
by imposing post-sale monitoring, reporting, and correction obligations on sellers of financial products.

I. POST-SALE MONITORING, REPORTING, AND CORRECTION FOR TANGIBLE CONSUMER PRODUCTS

The American legal system requires firms that sell tangible consumer products to monitor the safety of those products after they are sold, report to regulators evidence of any potential safety problems, and take corrective action to mitigate the impact of any such problems. Part A describes these monitoring, reporting, and mitigation requirements. Part B then articulates several potential justifications for these rules. First, firms and regulators cannot fully anticipate or appreciate product safety problems when products are initially sold to consumers. Second, firms that manufacture and distribute tangible consumer products enjoy some comparative advantages over governments and consumers in learning new, post-sale information regarding their product's safety. Third, regulators armed with new safety information about products can require firms to take corrective action that may efficiently mitigate safety problems.

A. An Overview of Product Manufacturers' Duties to Monitor, Report, and Correct Safety Problems

Sellers of tangible consumer products are required to report and correct known safety problems with their products. In particular, the Consumer Product Safety Act requires manufacturers, distributors, and retailers to report any information they acquire that reasonably supports the conclusion that one of their products contains a defect that could create a substantial product hazard, poses unreasonable risks, or fails to comply with voluntary or mandatory product safety rules. Upon receiving such a report, the Consumer Product Safety Commission (CPSC) makes a preliminary determination.

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11 Whether these justifications are ultimately convincing depends on various details that are beyond this Article's scope.

12 Of course, sellers and manufacturers of various other types of goods also face various post-sale obligations. These other categories of goods include foods, drugs, and automobiles. See Schwartz and Adler, 34 Case W Res L Rev at 402 (cited in note 6).


14 CPSA § 15, 82 Stat at 1221, codified at 15 USC § 2064(b).
of whether the underlying product presents a substantial hazard or risk. If the product presents such a danger, then the CPSC may order the reporting company to implement a corrective action plan that includes remedial action, possibly up to a “recall” of a product. In practice, the CPSC rarely mandates corrective action; voluntary product recalls are much more common. But as Anita Bernstein points out, many voluntary recalls are actually the result of an implicit or explicit threat by the CPSC to issue a mandatory recall.

In addition to establishing these requirements, the CPSC also incentivizes companies to report and correct product safety problems promptly. Under the CPSC’s “fast track” program, the agency generally refrains from making a preliminary determination regarding a product’s risks if the company implements effective corrective action within twenty days of filing a report with the CPSC. Avoiding an adverse preliminary determination helps to limit negative publicity, litigation risks, and the costs of complying with a mandatory corrective action order. Companies are excluded from the program if the CPSC believes that they delayed reporting a safety problem for any reason, including preparing a voluntary corrective action plan that would be more likely to be accepted under the “fast track” program. Collectively, these rules encourage companies to report and resolve safety problems quickly, as doing so promotes faster resolution of potential regulatory and safety problems while avoiding the potential risk that the CPSC will compel firms to take corrective action.

The CPSC’s reporting rules also encourage, and to some extent require, firms to proactively monitor consumer markets for potential dangers associated with their products. Firms are deemed to have acquired information about the safety risks of their products when that information “is received by an

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16 Id at 16–18.
17 Louis R. Frumer, Marvin I. Friedman, and Cary S. Sklaren, Products Liability § 57.04 (Matthew Bender 2012).
20 See id.
21 See id.
employee or official of the firm who may reasonably be expected to be capable of appreciating the significance of that information."22 Even more importantly, the CPSC deems a firm to know information that "it would have known had it exercised due care in analyzing reports of injury or consumer complaints, or in evaluating warranty returns, reports of experts, in-house engineering analyses, or any other information."23 These rules mean that firms can be in violation of their reporting requirements if they fail to reasonably monitor markets for safety problems. The CPSC also explicitly encourages firms to "develop a system for maintaining and reviewing information about their products that might suggest" product safety problems.24

B. Rationales for Post-Sale Obligations to Monitor, Report, and Correct Product Safety Problems

Many product safety problems cannot be anticipated or fully appreciated when products are first broadly sold to consumers.25 Often, this is simply because knowledge about the product itself is imperfect; the strength and resiliency of materials, the quality of manufacturing, and the drawbacks of product design are all subject to incorrect assessment ex ante. In other cases, firms may fail to evaluate safety problems because they do not anticipate consumer use patterns: consumers may systematically use products in ways that were not intended or expected, but which create unanticipated dangers. For instance, unwary consumers may use an electronic device such as a blow-dryer in the bathroom unless they are warned of the dangers of doing so. And in yet other cases, product safety may change because of changes in the environment in which the product is used—for instance, a tire may prove unsafe only once a new type of paving method becomes widespread. Such limitations on pre-sale safety assessments create a possible need for post-sale

23 Id at 9.
24 Id at 7.
25 See Omri Ben-Shahar, How Liability Distorts Incentives of Manufacturers to Recall Products *1 (U Mich Olin Center Working Paper No 05-002, Dec 2004), online at http://www.law.umich.edu CENTERSANDPROGRAMS/LAWANDECONOMICS/ABSTRACTS/2005/DOCUMENTS/05-002bensahahar.pdf (visited Sept 15, 2013) ("Usually, it is only over time, as experience mounts and as aggregate data becomes reliable, that specific risks and harms can be assessed, and precautions can be taken.").
reevaluation of product safety, as new information may alter the social costs and benefits of manufacturing and selling a particular product.

Given the potential value of post-sale safety assessments, it is sensible to allocate some of this burden to individual firms. Such firms are often well-situated to identify consumer accidents stemming from product safety problems.\textsuperscript{26} This is for a few reasons. First, firms often maintain ongoing relationships with their customers, fielding consumer complaints, inquiries, and comments. Firms do this to promote consumer satisfaction with products, generate brand loyalty, and conduct market research. Second, firms are often contacted directly—through lawyers, newspapers, medical staff, or victims—when their products are involved in an accident or other consumer harm. Third, companies obviously have a deep understanding of the intended and expected operations of their products. They are therefore in a strong position to identify accidents that result from unintended uses or unexpected behavior of their products.

Similar reasons may support compelling firms to report to regulators sufficiently serious safety problems with products that have already been sold. Such a requirement could help channel important information to regulators, who may be able to weigh the social costs and benefits of corrective action more objectively than the individual firm. On the basis of this information, regulators could compel the firm to take appropriate corrective action.\textsuperscript{27} Alternatively, and apparently more commonly, firms that are forced to report safety-related information to regulators might take preemptive corrective action in order to avoid regulatory compulsion.\textsuperscript{28} Not only can reporting promote more efficient and effective preemptive corrective action, but it might also allow safety regulators to

\textsuperscript{26} See Consumer Product Safety Commission, \textit{Recall Handbook} at 6–7 (cited in note 15) (“Although CPSC uses sources other than company reports to identify potentially hazardous products, reporting by companies under section 15 can provide the most timely and effective source of information about such products. This is because firms often learn of potential product safety problems at an early stage.”).

\textsuperscript{27} Assuming, of course, that the firm would not be willing to do so in the absence of regulatory pressure. Consider A. Mitchell Polinsky and Steven Shavell, \textit{The Uneasy Case for Product Liability}, 123 Harv L Rev 1437, 1440 (2010) (noting that firms may have market incentives, such as reputational gains, to correct safety problems with their products).

\textsuperscript{28} See Bernstein, 2013 U Chi Legal F at 384 (cited in note 18).
determine whether safety problems at one firm raise concerns about the products of other firms.

Finally, in cases where products pose sufficiently large safety problems, it is sensible to require companies to correct the problem under the watch of regulators. A firm that manufactures or designs a defective product is uniquely well-situated to remedy resulting safety problems, given its knowledge of the underlying product's design and materials. Moreover, regulatory scrutiny of such efforts should generally be effective, as regulators will be focused on a particular safety problem that has already manifested itself on the market, rather than a broad spectrum of potential risks. Moreover, placing this burden on firms that fail to detect safety problems ex ante seems likely to encourage better upfront precautions and research by forcing them to internalize the cost of post-sale corrective action.

Of course, the potential benefits of post-sale safety assessment, reporting, and corrective action are hardly assured. First, firms may be excessively reluctant to report or correct safety problems with products already in the hands of consumers if doing so can increase the risk of litigation. One potential approach to mitigating this concern is to limit liability when firms do take voluntary corrective action. Indeed, this is the central idea of the CPSC's fast track program, which relieves a firm of the burdens associated with a preliminary determination if it proactively and voluntarily takes corrective action. This idea is also implicitly embodied in the current products liability regime, which is more likely to impose punitive damages on firms that fail to take corrective action when safety problems become known.

Another potential drawback of post-sale product safety requirements is that they may cause firms to affirmatively avoid learning about safety problems in the first place in order to limit

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29 See Ben-Shahar, 14 J L Econ & Org at 340-44 (cited in note 4) (modeling this effect); Schwartz and Adler, 34 Case W Res L Rev at 417 (cited in note 6) (noting that recalls can stimulate additional lawsuits and bring adverse publicity); Steven Shavell, Liability and the Incentive to Obtain Information about Risk, 21 J Legal Stud 259, 261-68 (1992) (modeling the impact that liability may have on the incentives of potential injurers to learn about risk).

30 See Ben-Shahar, 14 J L Econ & Org at 350-51 (cited in note 4).

31 See notes 19-21 and accompanying text.

32 See, for example, General Motors Corp v Johnston, 592 S2d 1054, 1060-61 (Ala 1992) (awarding punitive damages due to GMC's failure to recall vehicles despite company knowledge of defective computer chips).
the costs of mandated disclosure or remedial action. Firms may, for instance, avoid proactively investigating possible product risks or be more likely to accept innocent explanations for consumer accidents. Of course, regulators can attempt to forbid this behavior, just as they require disclosure in the first place. Indeed, as described above, the CPSC does just this by imputing to a firm knowledge of any product safety information of which it should have been aware, irrespective of whether it actually knew this information. Nonetheless, this type of requirement is hard to enforce, as it requires measuring a firm’s actual efforts to monitor its products’ safety relative to those efforts it would have taken in the absence of a reporting requirement.

II. EXTENDING POST-SALE OBLIGATIONS TO SUITABILITY REQUIREMENTS FOR FINANCIAL PRODUCTS

In recent years, innovation in consumer financial protection has drawn heavily from the law governing the safety of tangible consumer products. The most well-known example is the creation of the CFPB, which was originally premised on the notion that regulators should protect consumers against “unsafe” financial products just as they have long protected consumers against unsafe toaster ovens and automobiles. The power of this analogy is that inappropriate or exploitive financial products can harm consumers in ways that are comparable in magnitude to the physical harms that unsafe tangible products can cause. And just as in the case of tangible product safety, market mechanisms alone cannot be relied upon to fully protect consumers because of limited consumer information about financial product risks and well-known cognitive biases and limitations among consumers.

To date, the analogy between tangible consumer products and intangible financial products has largely been used to justify
more capacious pre-sale regulation of consumer financial products. But this analogy can be extended to the legal regime governing post-sale monitoring, reporting, and correction of consumer financial products as well. As discussed above, three key features of tangible product markets potentially justify imposing post-sale obligations on firms: (i) firms’ uncertainty about product safety at the time of sale; (ii) firms’ informational advantages in detecting the results of product safety problems; and (iii) the potential value of reporting and correcting these problems. This Part will evaluate how these features might apply to consumer financial products by exploring how financial product suitability rules could be expanded to encompass post-sale monitoring, reporting, and corrective action requirements. Whether the benefits of such an expansion would outweigh the costs is beyond the scope of this Article.

A. A Brief Overview of Financial Product Suitability

Sellers of retail financial products in the insurance, securities, and credit domains are often required to ensure that the products they sell are appropriate for the specific consumers who purchase them. This requirement is most familiar in the securities context, where the SEC and various self-regulatory bodies have long required broker-dealers to have reasonable grounds for believing that the securities they sell to retail consumers are suitable for customers’ needs and situations. Suitability rules are of more recent vintage in the insurance context, having originated from the application of securities

37 See Part II.A.
38 See Kathleen C. Engel and Patricia A. McCoy, A Tale of Three Markets: The Law and Economics of Predatory Lending, 80 Tex L Rev 1255, 1321-22 (2002). The most recent version of this rule is Rule 2111 of the Financial Industry Regulatory Authority (FINRA), which requires that a firm or associated person “have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer’s investment profile.” FINRA Rule 2111(a). This rule is largely similar to its predecessor National Association of Securities Dealers (NASD) and New York Stock Exchange rules. See FINRA Regulatory Notice 11-25 (May 18, 2011), available on Westlaw at 2011 WL 2006978.

Dodd-Frank requires the SEC to study whether a fiduciary standard should be extended to broker-dealers as well. See Dodd-Frank § 914, 124 Stat at 1830. See also Donald C. Langevoort, Brokers as Fiduciaries, 71 U Pitt L Rev 439, 444 (2010). Of course, if such a standard were extended to brokers, it would still require that brokers ensure that products sold to clients were suitable for their need and situation.
regulations to hybrid insurance-securities products such as variable annuities and life insurance. In recent years, the model regulations of the National Association of Insurance Commissioners (NAIC) have extended suitability requirements to the sale of annuities of all types (including those that are not subject to federal securities law), as well as to the sale of long-term care insurance. And, as a result of the Dodd-Frank Act and the Credit Card Accountability Responsibility and Disclosure Act of 2009, a limited version of the suitability requirement will soon apply to providers of certain mortgages and credit cards, who will be required to ensure that consumers have “a reasonable ability to repay” loans or credit limits that are extended to them.

39 See Engel and McCoy, 80 Tex L Rev at 1321 (cited in note 38). See also NASD Notice to Members 00-44 (June 16, 2000), available on Westlaw at 2000 WL 1375112 (establishing securities-like regulation for hybrid insurance-securities products); NASD Notice to Members 99-35 (May 1999), available on Westlaw at 1999 WL 33176526; NASD Notice to Members 96-86 (Dec 1996), available on Westlaw at 1996 WL 1771364.


42 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub L No 111-203, 124 Stat 1376 (2010), codified in various sections of 12 USC.


44 See Dodd-Frank § 1411(a)(1), 124 Stat at 2142, codified at 15 USCA § 1639c ("In accordance with regulations prescribed by the Board, no creditor may make a residential mortgage loan unless the consumer has a reasonable ability to repay the loan."); Card Act § 109, 124 Stat at 1743, codified at 15 USC § 1665e ("A card issuer may not open any credit card account unless the card issuer considers the ability of the consumer to make the required payments under the terms of such account."). Certain qualified mortgages are exempted from this requirement. See Dodd-Frank § 1412(b)(2)(A), 124 Stat at 2145–46. Most commentator agree that ability to repay rules is a limited version of suitability rules. See Jonathan R. Macey, et al, Helping Law Catch Up To Markets: Applying Broker-Dealer Law To Subprime Mortgage, 34 J Corp L 789, 836 (2009) ("We take an assessment to pay to be a necessary, but not sufficient, precondition for a determination of suitability."); Jason Scott Johnston, From Nudges to Mandates: Dodd-Frank Mortgage Regulation as Case Study *13 (University of Virginia Law School Working Paper, Dec 2012), online at http://www.masonlec.org/site/rte_uploads/files/Johnston%20nudges%20mandates%20dodd%20as%20case%20study%20FINAL.pdf (visited Sept 15, 2013) (noting that the ability to repay standard is “intentionally, very similar to the ‘suitability’ standard that applies to broker/dealers under the federal securities law”); John A. E. Pottow, Ability to Pay *12 (University of Michigan Law School Program in Law and Economics Working Paper, May 2011), online at http://www.law.berkeley.edu/files/bclbe/Ability_to_Pay.pdf (visited Sept 15, 2013).
In all of these cases, regulations and statutes implementing suitability review focus predominantly on the time prior to sale. For example, the Financial Industry Regulatory Authority ("FINRA") suitability rules are only triggered when a broker makes a recommendation with respect to an "investment strategy involving a security or securities." Such recommendations "normally would not create an ongoing duty to monitor and make subsequent recommendations." Similarly, FINRA rules only require firms to collect customer information before making new recommendations. The NAIC's suitability rule for annuities similarly focuses on evaluating whether an annuity is suitable for a customer prior to its issuance. The only post-sale obligation imposed on insurers by the NAIC annuity rule is to "annually provide a report to senior management reasonably designed to determine the effectiveness of the [suitability] supervision system, the exceptions found, and corrective action taken or recommended, if any." As described in more detail in Part III, Dodd-Frank's ability to repay rules similarly focus on pre-sale procedures and safeguards.

To be sure, financial regulators do occasionally supplement suitability rules—as well as other financial regulations—with a broad requirement that firms maintain compliance programs. In some cases, these compliance programs may retrospectively evaluate procedures designed to ensure suitable sales. However, there are few (if any) rules requiring compliance programs to monitor post-sale product data to identify the consequences of

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45 FINRA Rule 2111(a).
46 FINRA Regulatory Notice 12-25 at 7 (May 18, 2012), available on Westlaw at 2012 WL 1898671.
47 Id at 12.
48 See National Association of Insurance Commissioners, Suitability in Annuity Transactions Model Regulation § 2 at 275-1 (cited in note 40). The NAIC rule applies to any recommendation involving an annuity transaction by an insurer. Notably, a recommendation must result in the purchase, exchange, or replacement of an annuity to fall under the purview of the rule. See id § 5(G) at 275-2. At the time of sale, an insurer must record any recommendation made to the consumer that would be subject to the rule. See id § 6(E)(1) at 275-5. Twenty-seven states have adopted the most recent version of this law in "substantially similar" form. See id at ST-275-3–8.
49 Id at § 6(F)(1)(f) at 275-6.
50 See Part III.
failed suitability procedures. Nor are such compliance programs required to report problems to regulators or proactively take corrective action.

B. Post-Sale Obligations and Financial Product Suitability

Despite the pre-sale focus of financial product suitability regulation, the tangible consumer product framework suggests that regulatory requirements aimed at post-sale review of suitability determinations may be appropriate. First, as with safety problems in tangible consumer products, firms cannot always accurately assess the suitability of financial products on a pre-sale basis. In some cases, firms may fail to fully anticipate how their products will operate in unusual market conditions. As FINRA explained in a 2012 release on consumer suitability and sales supervision, "[e]very product presents risks that may cause the product to perform differently than anticipated, particularly when market conditions have changed."52 For this reason, FINRA recommends as a “best practice” that financial firms review, on a post-sale basis, the effectiveness of suitability procedures for new products.53 Similarly, the UK’s Financial Services Authority recently released guidance on the creation of structured products, which advised firms to monitor products “through to the end of [their] life cycle.”54

In other cases, firms may fail to accurately evaluate the suitability of financial products at the time of sale because they do not elicit relevant information from consumers.55 This might

52 FINRA Regulatory Notice 12-03 at 7 (Jan 17, 2012), available on Westlaw at 2012 WL 171510.
53 See NASD Release 05-26 at 1, 8 (Apr 6, 2005), available on Westlaw at 2005 WL 775434 (stating that firms should “track and monitor customer complaints and grievances relating to new products” and formally recommending “post-approval follow-up and review” for new products to “assess product performance, determine whether product limitations and other post-sale compliance requirements are met, and to evaluate whether market conditions have altered the risks associated with the product.”).
55 See, for example, Order Accepting Offer of Settlement, Department of Enforcement v Buswell, et al, FINRA Disciplinary Proceeding No 2009017275301, “26–27 (Sept 27, 2011), online at http://disciplinaryactions.finra.org/viewdocument.aspx?DocNB=22668 (visited Sept 15, 2013) (finding that “the firm’s new account application process was flawed” and that “the reviewing principal was unable to obtain an accurate picture of the customer’s financial status, investment objectives, and investment history
occur because the company's questions are confusing or incomplete. Alternatively, salespeople may simply neglect to inquire about relevant information due to inadequate training.\textsuperscript{56}

Another reason that firms' pre-sale suitability procedures may fail is that employees or agents may inadvertently or intentionally flout those rules. Suitability rules are generally in place precisely because salespeople have incentives to sell certain products in order to maximize commissions, bonuses, and short-term profits.\textsuperscript{57} Accordingly, unethical salespeople may intentionally subvert suitability rules in order to sell, and earn, more.\textsuperscript{58} Perhaps more commonly, individual sellers of financial products may push ambiguous boundaries to justify unsuitable sales because doing so promotes their financial interests.

The second feature of suitability rules that potentially makes the imposition of post-sale review obligations feasible is that, as with safety problems in tangible consumer products, individual firms are comparatively well-situated to detect suitability problems that were not identified at the time of sale. Sales of unsuitable products will, of course, often result in consumer complaints when consumers ultimately realize the negative results of their purchase. For instance, a consumer may realize that she was sold an unsuitable annuity when she learns that she must pay a large surrender fee in order to withdraw

\textsuperscript{56} See, for example, Letter of Acceptance, Waiver, and Consent, Department of Enforcement \textit{v} Steven Krasner, FINRA Disciplinary Proceeding No 2009019995901 *2 (Sept 7, 2011), online at http://disciplinaryactions.finra.org/viewdocument.aspx?DocNB=21968 (visited Sept 15, 2013) (finding that "the [ ] database and computer platform that [the respondent] used to place trades, as well as the account statements that were mailed to [the customer] each month, inaccurately indicated that the investment objective was speculation. In his conversations with [the customer], [the respondent] never confirmed the accuracy of the investment objective").

\textsuperscript{57} Engel and McCoy, 80 Tex L Rev at 1318–21 (cited in note 38).

\textsuperscript{58} Such salespeople may systematically report false information, elicit inaccurate information from consumers, or otherwise undermine internal procedures designed to ensure suitable sales. See, for example, Letter of Acceptance, Waiver, and Consent, Department of Enforcement \textit{v} Jan Henderson, FINRA Disciplinary Proceeding No 20090195139 *2 (July 13, 2011), online at http://disciplinaryactions.finra.org/viewdocument.aspx?DocNB=18848 (visited Sept 15, 2013) (finding that respondent "switch[ed] customers from their existing fixed and/or variable annuities into a [specific] variable annuity thereby improperly earning additional commissions at the expense of customers who paid substantial surrender fees"). See also Sally Balch Hurme, \textit{Who's in the Batter Box?: Regulating and Litigating Unsuitable Sales of Variable Annuities}, 1 Phoenix L Rev 365, 386 (2008) (describing a case where respondent "sold three annuities to a terminally ill eighty-six-year-old man").
funds. Alternatively, a consumer sold an unsuitable mortgage may only realize that fact when he does not have the ability to pay his monthly bill when the initial teaser rate ends.

Relative to their counterparts in tangible consumer markets, sellers of retail financial products actually have a superior ability to detect these consequences of unsuitable sales. This is because financial products are contracts that typically create long-term relationships requiring regular and detailed contact with customers. Financial firms’ ordinary business operations thus provide them with the capacity to spot unusual patterns of defaults, delinquencies, surrender charges, or other markers of unsuitable sales.

Individual financial firms are well-situated not only to identify the consequences of unsuitable sales, but also to identify their sources. Firms routinely evaluate their employees’ and agents’ performances; like all companies, retail financial firms have an interest in the productivity of their employees and independent contractors. This ordinary business process affords financial firms an opportunity to identify salespeople who fail to comply with procedures designed to ensure suitable sales. Similarly, firms obviously track the performance of individual financial products in order to assess trends and market needs. Here too, retrospective evaluation in the ordinary course of business should allow firms to identify unsuitable sales relatively easily.

The third and final feature of suitability rules that makes post-sale review obligations feasible is that, by proactively addressing unsuitable sales, firms can avoid harm to individual consumers. In many cases, the sale of an unsuitable product can be remedied through the provision of a replacement product or

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59 For example, in 2005, a class action lawsuit was filed against insurer Allianz, which was alleged to have sold actuarially unsuitable annuities to elderly consumers. See Chris Serres, A Split Decision in Allianz Life Annuity Lawsuit, Minneapolis Star Tribune A1 (Oct 14, 2009). Allianz reportedly enticed these customers with significant interest bonuses; unfortunately, it imposed even heavier fees on early withdrawals from the annuity accounts. For instance, the named plaintiff, a sixty-five-year-old woman, received a 10 percent up-front bonus on her investment of $216,189—but would have to pay surrender charges of 12.5 percent for withdrawals within the first fifteen years. While this arrangement might prove beneficial to a younger customer, it prevented many purchasers from withdrawing their money penalty-free for a period well beyond their life expectancy.

the waiver of a contractual condition. These options are largely analogous to a product manufacturer recalling a tangible product or devising a supplemental patch for a product. In either the tangible good or financial product situations, the selling firm can reduce the risk of post-sale harm caused by the defective product by using information that it has obtained in the course of its everyday business operations.

In sum, each of the three justifications for imposing post-sale obligations on manufacturers of tangible consumer products has potential application to suitability rules for intangible consumer financial products. Perhaps not surprisingly, though, so too do the critiques of such obligations in the tangible product market. Imposing post-sale obligations on retail financial firms may accomplish little if firms resist corrective action for fear of lawsuits. And such obligations could, in theory, cause sellers of retail financial products to intentionally turn a blind eye to regulatory violations in order to avoid triggering their post-sale obligations in the first place.

Ultimately, the feasibility, benefits, and costs of any potential post-sale suitability review regime depend on numerous factors that are context-specific. But the exclusive focus of suitability regimes on the point of sale is neither inevitable nor obviously desirable. Given the parallels between suitability and tangible product safety, there is at least reason to consider whether the suitability requirements imposed on sellers of financial products should include post-sale monitoring, reporting, and corrective action obligations.

III. APPLYING THE PRODUCT RECALL FRAMEWORK TO THE CFPB’S ABILITY TO REPAY RULES

Part II demonstrates that suitability requirements share some key characteristics with product safety requirements that may justify imposing on financial firms post-sale monitoring, reporting, and corrective action requirements. But it does little to illustrate how such an approach might operate on the ground floor. This Part attempts this more fine-grained analysis by looking at the CFPB’s recent attempt to implement limited

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61 See Part I.B.
62 See id.
suitability rules in the mortgage sales context. Of course, both the details for how best to implement a post-sale enforcement regime and the ultimate wisdom of doing so are likely to vary, even within the broad domain of suitability rules. Thus, a post-sale enforcement regime for ensuring suitable mortgages might look very different than one designed to ensure appropriate credit card limits, for instance, as unsuitable credit card loans are particularly profitable for issuers. But exploring the practical application of a post-sale enforcement regime in the specific context of the ability to repay rules helps both to concretize the core idea of this Article and to frame some of the potential difficulties and objections.

A. New Ability to Repay Rules

The Dodd-Frank Act requires that a mortgage lender make a good faith effort to verify a borrower’s ability to repay a loan before actually making such a loan. To do so, lenders must consider eight factors: (1) current or reasonably expected income or assets; (2) current employment status; (3) the monthly payment on the covered transaction; (4) the monthly payment on any simultaneous loan; (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. In effect, these rules impose a limited suitability requirement on mortgage lenders that applies to one core element of the transaction: the consumers’ ability to repay. Dodd-Frank also establishes a presumption of compliance with this rule for purposes of litigation when consumers are sold “qualified mortgages.” “Qualified mortgages” may not have any particularly risky features, such as negative amortization or balloon payments, and must meet minimum underwriting standards.

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63 See Part II.
64 See, for example, Ronald J. Mann, Bankruptcy Reform and the “Sweat Box” of Credit Card Debt, U Ill L Rev 375, 385 (2007).
65 Dodd-Frank § 1411(a)(2), 124 Stat at 2142, codified at 15 USC § 1639c.
66 Dodd-Frank § 1411(a)(3), 124 Stat at 2143, codified at 15 USC § 1639c(a)(3).
67 See text accompanying note 57.
68 Dodd-Frank § 1412(b)(1), 124 Stat at 2145, codified at 15 USC § 1639c(b)(1).
69 See Dodd-Frank § 1412(b)(2), 124 Stat at 2145–48, codified at 15 USC § 1639c(b)(2).
In January 2013, the CFPB promulgated final rules implementing these provisions.70 The CFPB's rules provide lenders with flexibility in the underwriting models they use to actually assess the eight statutorily-prescribed underwriting factors.71 They also create an absolute litigation safe harbor for loans that meet the definition of a qualified mortgage and are not "higher-priced."72 "Higher-priced" mortgages are determined by a complex formula that roughly captures the subprime market.73 Such higher-priced mortgages are entitled only to a rebuttable presumption of compliance with the ability to repay rules, even if they are qualified mortgages.74

B. Reconsidering the Ability to Repay Rules in Light of the Post-Sale Product Safety Framework

How might the post-sale product safety framework apply to the CFPB's proposed rules implementing Dodd-Frank's ability to repay requirement? First, and perhaps most importantly, this framework suggests the possible wisdom of requiring creditors to back-test the accuracy of their particular underwriting models by assessing whether ex post data on actual default rates match the ex ante predictions of their models.75 As with sellers of tangible goods, even well-meaning financial firms cannot fully anticipate the various ways in which their particular


71 See id at 6408 ("Creditor must generally use reasonably reliable third-party records to verify the information they use to evaluate the factors.").

72 See id at 6409 ("[T]he final rule applies the new ability-to-repay requirements but creates a strong presumption for . . . qualified mortgages. [ ] [I]f a prime loan satisfies the qualified mortgage criteria . . . it will be conclusively presumed that the creditor made a good faith and reasonable determination of the consumer's ability to repay.").

73 "Higher-priced" mortgages are defined by a 2008 Federal Reserve Rule, which subjected only these mortgages to an ability to repay requirement. See 12 CFR § 226.35(a). The definition targeted loans with interest rates substantially above those prevailing in the market place. See 12 CFR § 226.35(a)(1).

74 See 78 Fed Reg at 6408 (cited in note 70) ("The final rule provides a rebuttable presumption for higher-priced mortgage loans . . . if creditors follow [newly strengthened] requirements.").

75 One potential first step towards promoting back-testing would be for the CFPB to use the default and foreclosure database mandated by Section 1447 of Dodd Frank to determine if certain lenders are outliers. The proposal here, however, would go one step beyond this by requiring individual firms to back-test their own models and potentially report troubling results to the CFPB.
underwriting models may fail to identify consumers who do not, in fact, have a realistic ability to repay a loan.\textsuperscript{76}

Evaluating product performance with post-loan data could allow firms to identify problems with their underwriting models that were not discernible ex ante. For instance, such testing might reveal that a certain segment of consumers—perhaps those with high debt levels and volatile incomes—are at a much greater risk of default than the model predicts. Alternatively, back-testing might reveal that a firm’s underwriting model works well in some geographic regions but not others, or that consumers who work with a particular broker or group of brokers experience unexpectedly high default rates.

A requirement to back-test ability to repay assessments is consistent with the safe harbor and presumption of compliance embedded within the current ability to repay rules.\textsuperscript{77} These rules limit the potential liability of creditors, but not the prospect of future regulatory scrutiny. In fact, the liability-limiting safe harbor and presumption in current law actually provide support for implementing a back-testing requirement on lenders: without systematic ex post scrutiny, lenders would face limited pressure to reassess the accuracy of their underwriting models under the current regime.\textsuperscript{78}

The second potential lesson offered by the post-sale product safety lens is that firms that do identify problems with their underwriting models through back-testing should be required and/or incentivized to report those problems to the CFPB.\textsuperscript{79} As with individual firms, the CFPB has imperfect knowledge about how best to assure consumers’ ability to repay. By receiving feedback from individual companies about ways in which their underwriting standards fail to achieve this regulatory objective, the CFPB can consider the need to alter its rules or to request that other creditors back-test their models to look for particular anomalies. Mandatory reporting of potential problems with underwriting models to the CFPB would also encourage firms to take these problems seriously by subjecting them to the

\textsuperscript{76} See Part II.B.

\textsuperscript{77} See 78 Fed Reg at 6408 (cited in note 70).

\textsuperscript{78} Lenders might eventually face some media or consumer scrutiny if their underwriting models performed poorly. But the sub-prime mortgage crisis suggests that such pressure may not be sufficient to dissuade lenders from making unsafe loans.

\textsuperscript{79} See Part I.B.
independent, and more objective, analysis of the CFPB on the extent of the problem.

The post-sale product safety framework also suggests potential methods for successfully inducing firms to report problems with their underwriting models to the CFPB. For instance, the CFPB could implement a program similar to the CPSC’s fast track program, agreeing not to take any regulatory action if firms voluntarily report and correct observed problems with their underwriting models and practices. And, as in the fast track program, the CFPB could refuse to extend such protection to creditors that delayed reporting potential failures of their underwriting standards.

Third and finally, it might well be sensible for mortgage law to mimic the law of product recalls by requiring creditors to offer mortgage modifications to consumers who, at the time of sale, were incorrectly informed about their ability to repay a mortgage. Just like an unsafe tangible product, consumers who are sold mortgages that they predictably cannot afford face a very real risk of serious harm. By modifying the original mortgage product, it may be possible to limit the resulting consumer harm. Such modifications might be less costly than their analogue in the tangible product sphere, as redrafting contracts is generally easier than retrofitting or recalling defective tangible products. Arguably, though, it might violate the spirit of the Dodd-Frank ability to repay safe harbor, which strives to limit liability risk for qualified loans, which are presumed to be relatively safe.

As above, the law governing tangible products also offers some possible lessons for effective implementation of any such post-sale corrective action rules in the mortgage context. For instance, given the evidence that many firms are reluctant to issue product recalls because doing so could open them up to lawsuits, it might be sensible to offer legal immunity to firms

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80 See Part I.A.
81 To be clear, this proposal would not apply to borrowers who were correctly determined to have a reasonable ability to repay at the time of sale, but whose circumstances changed after the sale in a manner that could not plausibly have been known at the time of sale.
82 See Engel and McCoy, 80 Tex L Rev at 1319 (cited in note 38) (proposing that those who are sold unsuitable loans should have the right to sue for loan reformation).
83 See Part III.A.
84 See Part I.B.
that offer CFPB-approved modifications, at least to the extent that those firms are subject to liability risk in the first place. Alternatively, the availability of punitive damages could be explicitly tied to the extent to which a lender proactively remedied any problems with its underwriting models.

Any of these proposals, of course, would face a variety of legitimate objections and complications. For instance, originators' sale of mortgage loans to secondary markets might substantially complicate the logistics of imposing post-sale obligations on originators. This, in turn, could undermine the availability of credit. Even if this difficulty could be overcome, imposing new obligations on creditors would likely increase the cost of credit. It is even conceivable that placing post-sale obligations on firms to correct flawed underwriting models could exacerbate systemic risks if failures in these models were pervasive and correlated across companies. At the same time, there is substantial debate about how pervasive the underlying problem of lenders offering unaffordable loans will continue to be, given recalibrated expectations about real estate markets. And, of course, the actual effectiveness of the post-sale monitoring, reporting, and corrective action ideas explored above would depend on innumerable factors, including their actual implementation.

Detailed analysis of these complicated trade-offs is beyond this Article's scope. Thus, this Article does not contend that imposing post-sale monitoring, reporting, and corrective action obligations on sellers of retail financial products generally, or mortgage providers in particular, would ultimately be wise social policy. Instead, its core argument is that the ideas generated by applying the post-sale tangible product safety framework to issues such as ability to repay rules are worthy of serious consideration. Ultimately, the wisdom of imposing post-sale obligations on consumer financial firms depends on various context-specific factors.

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85 See generally Michael Simkovic, Competition and Crisis in Mortgage Securitization, 88 Ind L J 213 (2013).
86 See Todd J. Zywicki and Joseph D. Adamson, The Law and Economics of Subprime Lending, 80 U Colo L Rev 1, 1, 4 (2009) (emphasizing that imposing regulatory costs on lenders will result in higher costs for borrowers).
Tangible and intangible consumer products are similar in many ways, so distinctions in the legal regimes that govern them merit attention. Nowhere was this intuition better captured than in now-Senator Elizabeth Warren’s initial proposal to create the Consumer Financial Protection Bureau:

It is impossible to buy a toaster that has a one-in-five chance of bursting into flames and burning down your house. But it is possible to refinance an existing home with a mortgage that has the same one-in-five chance of putting the family out on the street—and the mortgage won’t even carry a disclosure of that fact to the homeowner. Similarly, it’s impossible to change the price on a toaster once it has been purchased. But long after the papers have been signed, it is possible to triple the price of the credit used to finance the purchase of that appliance, even if the customer meets all the credit terms, in full and on time. Why are consumers safe when they purchase tangible consumer products with cash, but when they sign up for routine financial products like mortgages and credit cards they are left at the mercy of their creditors?88

Building on this intuition, this Article suggests that the web of statutory and regulatory rules governing the post-sale obligations of firms to monitor, report, and correct product safety problems is also potentially applicable to intangible consumer financial products. As with product safety, regulatory issues in the domain of consumer financial protection often involve ex ante uncertainty about effective regulatory compliance. And as with product safety, firms may have a comparative advantage, vis-à-vis regulators, in detecting and mitigating the consequences of regulatory problems as they arise.

This Article illustrates these points through the prism of suitability rules generally, and the CFPB’s ability to repay rules in particular. But various other mechanisms of consumer financial protection might also be amenable to this analysis. For instance, the effectiveness of mandatory disclosure

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88 Warren, 5 Democracy at 8 (cited in note 9).
requirements, like suitability rules, may be hard to assess ex ante; the consequences of poor disclosure may be particularly visible to firms; and proactive market intervention may be able to mitigate the negative consequences of failed disclosure.89 Similarly, rules prohibiting discrimination on the basis of impermissible consumer characteristics may be amenable to post-sale monitoring, reporting, and correction obligations for firms. Here too, firms face a limited ability to gauge compliance prior to sale, are reasonably well-situated to detect the consequences of ineffective compliance, and might be able to mitigate the consequences through proactive measures after the sale. Ultimately, the law governing product safety may offer important lessons for effectively regulating consumer financial products that extend beyond those that originally inspired Elizabeth Warren to propose the CFPB.

89 For some similar reasons, securities issuers have a duty under current law to update disclosure statements that were accurate when made but subsequently became inaccurate due to changed circumstances. See Steven E. Bochner and Samir Bukhari, *The Duty to Update and Disclosure Reform: The Impact of Regulation FD and Current Disclosure Initiatives*, 7 Stan J L, Bus, & Fin 225, 246 (2002).