A dismal failure in regulating predatory lending practices

Wayne Koprowski
Dominican University

Khalid A. Razaki
Dominican University

ABSTRACT

This paper analyzes certain aspects of the Dodd-Frank Act of 2010 to determine whether, in fact, the Act delivered on its promise of reform in the mortgage lending industry and protection of the financial consumer from predatory lending practices. The paper also examines the Act with respect to the recommendations suggested in Alonzi et al (2010) to ascertain how many, if any, of those recommendations were addressed in the Act.

The Act, which was formally enacted on July 21, 2010, is over 2200 pages long. Many of the sections are enabling provisions and amendments to current laws. The authors believe that it dismally fails to create a safe, properly regulated, and equitably even playing field for participants in the mortgage industry. In summary, the Act does address some blatant past failings of mortgage lenders, yet fails to provide adequate powers or funding to prevent the malpractices. For instance, (1) the Act does not prevent incentive payments to mortgage originators based upon the number of loans originated of any quality, and (2) Adjustable Loan Mortgages (ARMs) and Nonstandard Loans are still permissible. Finally, the Act contains a significant "safe harbor" loophole permitting lenders to presume that a borrower has the ability to repay the loan.

Keywords: Mortgage lending, Dodd-Frank Act, predatory practices, Consumer Financial Protection Bureau, bank executive compensation

Background of Current Financial Crisis

There is a voluminous amount of literature on the causes of the mortgage banking crisis that became commonly observable in 2008. Alonzi et al [2010], among many other research tomes, have held almost all participants in the U.S. financial markets guilty of gross neglect, if not outright malfeasance in the recent global economic crisis. This group includes investment bankers, commercial bankers, mortgage lenders, rating agencies, auditors, auditing regulators, financial accounting regulators, sub-prime borrowers, real estate appraisers, real estate brokers, insurers, and a multitude of governmental units (the Congress, the Federal Reserve System, the Securities and Exchange Commission, federal and state banking regulators). There are two fundamental causes of the grave crisis that enabled the exploitation of an unfettered capitalistic, free market global economy resulting in pathological, unconscionable and abnormal profits for a few market participants at the expense of others: (1) lack of effective regulation to prevent malfeasance by the above listed parties and a failure to protect other naïve, injured market participants, and (2) a miserable failure by regulators across a broad spectrum, for political or ideological reasons, even to enforce those rules that were in existence. This blatant lack of regulatory oversight resulted in not only economic losses for injured market participants, but it also devastated innocent non-market actors, because this rape of the financial and governmental sectors has led to massive layoffs and threats of the dismantling of the economic security net of most Western economies.

Once the severe magnitude of the economic crisis and the consequent threat to the very existence of the global financial system were recognized, there were strident calls for the reform of regulation and oversight policies and practices. Analytical studies [for example, see McCoy (2010)] revealed the weaknesses of the regulatory system and the subversive role that regulators played by either relaxing the regulatory standards or by flagrantly failing to enforce them.

Much has been written about the financial crisis and the after effects. Razaki et al (2010) discussed the moral hazard which led to one of the greatest financial collapses in recent history. One of the consequences resulting from the fallout of the financial crisis was the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act, better known as the Dodd-Frank Act of 2010 (“Act”). The Act, which was meant to address the abuses contributing to the financial crisis, was hailed as “reform” by the Act’s sponsors.

This paper will analyze certain aspects of the Act to determine whether, in fact, the Act delivered on its promise of reform. The paper will also analyze the Act with respect to the recommendations suggested in Alonzi et al (2010) to ascertain how many, if any, of those recommendations were addressed in the Act.

The Act, which was formally enacted on July 21, 2010, is over 2200 pages long. Many of the sections are enabling provisions and amendments to current laws. The Act does address a number of issues related to the sub-prime lending cases. However, in other cases, the authors believe that it dismally fails to create a safe, properly regulated, and equitably even playing field for participants in the mortgage industry.

Partial Solutions Included in the Act:

The financial crisis was precipitated in part by a system which rewarded mortgage brokers and lenders who originated large and sometimes very risky loans. Alonzi et al (2010) developed an economics model demonstrating that mortgage bankers have a perverse incentive to make unsafe and risky loans for personal financial gain to the detriment of other parties involved in the lending transactions and the secondary market investors. Alonzi (2010) identified several factors which were the root causes of the crisis. These included (1) no equity stake in the loan, (2) interest free loans, (3) no proof of income and (4) adjustable rate mortgages. Lenders received their compensation merely by processing loans and then factoring the loan to another lender. There was every incentive to originate "more loans, larger loans and loans with riskier features." (Marquand, 2011, p 292). These loans were then aggregated into portfolios of loans and sold as "mortgage backed securities." Securitization effectively eliminated the risk to lenders. See (Marquand, 2011), Alonzi et al (2010), and Razaki et al (2010).

Borrowers were enticed to take out loans which far exceeded the borrower's ability to repay. In Razaki (2011), it was noted that there were numerous federal agencies which had some oversight responsibility in regulating the mortgage industry. Yet despite this extensive menagerie of regulatory surveillance, lax enforcement by these agencies aided in the near collapse of the banking industry. It was the abusive practices of certain segments of the mortgage industry combined with lax enforcement that the Act was intended to address, among other financial issues.

Lower risk standards/stated income:

One of the serious issues identified by Alonzi (2010) and Alonzi et al (2010) as a major cause of the lending crisis was the lowering of lending standards. As mentioned previously, the reason is obvious: to increase the volume of loans, many of which were extremely risky, in order to exploit management's superior knowledge and gain excessive and undeserved financial remuneration for bank managers. This exploitation resulted in fatter paychecks for loan originators and lenders. This situation created a perfect storm when one considers that the loan originator was then able to sell that risky loan to the secondary market. The originator had "no skin in the game…" (securitizer had no risk). Not only was there no risk, but the originator was handsomely rewarded for generating the risky loan.

Coupled with lower lending standards was the common practice of overlooking a borrower's ability to repay the loan. In many instances, a potential borrower was not even required to verify his or her income ("stated income loans," also called "liar's loans" within the industry) (Marquand, 2011, p 293). Stated income loans began as a product designed to facilitate lending to individuals with difficult to document incomes: those working on commission, the self-employed with incomes that fluctuated from year-to-year, and other non-traditional borrowers. It was a laudable objective because it enabled non-traditional borrowers to purchase homes that they could afford. But it became reminiscent of the old adage, "no good deed goes unpunished" because it provided a loophole to some unscrupulous lenders to initiate loans that should never have been made because the borrowers were incapable of paying them back. Marquand (p 294) further states that "in some areas of the country, one-half of new mortgages were of the stated income variety … At Washington Mutual, a large lender that dealt heavily in stated income loans, eighty-eight percent of loans were stated income loans."

In addition, loan originators embarked on the burgeoning practice of offering "subprime" loans. A subprime loan is defined as a "type of loan normally made out to borrowers with lower credit ratings. As a result of the borrower's lowered credit rating, a conventional mortgage is not offered because the lender views the borrower as having a larger-than-average risk of defaulting on the loans." [http://investopedia.com/terms/s/subprim]. Marquand (2011, p 294) reports that by the end of 2006, subprime mortgages, many of which were stated income loans, accounted for almost fifteen percent of the $10 trillion total mortgage debt.

When savings and loan institutions were a source of most residential home loans, the system in place at the time required the lender to retain the risk of the loan on its books, thereby providing an incentive on the part of the lender to minimize risk through stricter lending standards. However, with the advent of securitization, lenders were provided an opportunity to sell riskier loans in the secondary markets to investors without the risk of being responsible themselves for underwriting a bad loan and being penalized. In short, there was little or no accountability on the part of lenders for violating rules of prudent lending.

The Act attempts to address these issues in at least two ways: First, Credit Risk Retention by Mortgage Bankers, and second, Assurance of Credit Worthiness. Title XIV of the Act amends certain provisions of the Truth in Lending Act ("TILA") by requiring the loan originator to evaluate the credit worthiness of a borrower's ability to repay the loan. Specifically, section 1402(a) states that the TILA amendments are designed for "enhanced protection, limitation and regulations of terms of residential mortgage credit…while insuring that responsible, affordable credit remains available to consumers." The Act amends TILA by adding a new Section 129B(a)(2) which "assures that consumers are offered and receive residential mortgage loans on terms that reasonably reflect their ability to repay loans that are understandable and not unfair, deceptive or abusive." Section 1402 of the Act further provides that the "Board shall prescribe regulations to prohibit mortgage originators from steering any consumer to a residential mortgage loan that (i) consumer lacks the ability to repay" or "mischaracterizes the credit history of consumers or mischaracterizes the appraisal value of property." Section 1411(a)(2) of the Act sets forth "Minimum Standards" concerning a consumer's ability to repay. "No creditor may make a residential mortgage loan unless the creditor makes a reasonable and good faith determination based on verified and documented information that, at the time the loan is consummated, the consumer has a reasonable ability to repay the loan….." Section 1411(a)(3) provides several criteria for making such a determination, including:

- Consideration of credit history
- Current income
- Expected income
- Debt to income ratio
- Employment status
- Other financial resources

Section 1411(a)(4) requires that a "creditor making a mortgage loan shall verify amounts of income or assets including expected income or assets by reviewing W-2 tax returns, payroll receipts, financial records."

Reflecting on these provisions, they appear both reasonable and practical. Yet incredibly, in the period leading up to the financial crisis, none of these common sense requirements had been required for a home loan.

It is worthy to note that the Act provides that "No provision shall be construed …as prohibiting incentive payments to mortgage originators based on the number of residential mortgage loans originated." [Section 1403 amending TILA section 129B(c)(4)(d)]. In other words, the fox is still watching the henhouse.

Furthermore, section 1412(b) provides lenders with a "safe harbor" provision that permits a "Presumption of Ability to Repay." Section 1412 amends Section 129C of TILA by adding a new section 129C (b)(1) which states that "any creditor with respect to any residential mortgage loan … may presume that the loan has met the requirements of subsection (a) if the loan is a 'qualified mortgage'". The definition of a "qualified mortgage" as stated in Section 129C (b) (1) (A) of TILA is quite extensive and detailed. Some of the significant requirements for a qualified mortgage include a loan (i) "for which regular periodic payments do not result in an increase of the principal balance nor allow the consumer to defer repayment of principal"; (ii) "does not result in a balloon payment that is more than twice as large as the average scheduled payments"; (iii) 'in the case of a fixed loan, …, is based on a payment schedule that fully amortizes the loan"; and, (iv) "for which the term of the loan does not exceed thirty years."

Risky loan products and practices:

During the heyday of the home lending boom, mortgage lenders developed creative, but risky, loan products and practices. These included no interest loans and adjustable rate loans (ARM's). Surprisingly, even though the Act seems to frown on these risky practices, it does not prohibit them. Sections 1411(6) still allows "Nonstandard Loans" such as "variable rate loans that defer repayment of any principal or interest" but does require an amortization schedule and detailed calculations to be completed by loan originators in order to substantiate a borrower's ability to repay. When making these calculations, a lender must use third party information such as a borrower's IRS form W-2's, tax returns or pay stubs to verify income (Marquand, 2011, p 296).

In reviewing the Act, it is apparent that it does address some of the serious abuses. But are they merely band aids for curing a potentially fatal disease? For example, nowhere does the Act address the issue of lax regulation by the various governmental agencies charged with the responsibility of overseeing the mortgage lending industry. This is a serious and glaring failure. It does, however, create another bureaucratic regulatory agency , the Consumer Financial Protection Bureau (CFBP). This agency will be discussed later.

Alonzi et al (2010) Recommendations and ACT Provisions.

Alonzi et al (2010) made several recommendations to rectify this poisonous situation that was a major factor in the ensuing global economic crisis. These recommendations applied not only to mortgage bankers and lenders but also to rating agencies, investment bankers, numerous federal regulatory agencies, auditors and accountants. Even though the focus of this paper is on abuses in mortgage lending, all of the recommendations of Alonzi et al (2010) will be examined to determine if the ACT addresses them and provides any solutions to them.

Alonzi et al [2010] made several recommendations regarding the Management Compensation Structure for bank management to redress the most glaring causes of the financial crisis. They also cautioned that any legislated reforms must be systemic and backed and enforced by the full force and authority of the federal government. The recommendations and the Act provisions, if any, are listed below.

Recommendation 1: Management Compensation Structure for Bank Management – The Claw Back Provision.

Alonzi et al (2010) recommended instituting a "claw back" compensation scheme. Claw backs would result in the recapture of previously paid compensation to bank management. The claw backs are intended to atone for the dysfunctional, loan-related managerial decision-making sins of the past that in some cases amounted to malfeasance.

The common practice of basing bank management's compensation upon reported earnings created a perverse incentive for managers to manipulate profitability. Bank management exploited its possession of asymmetric information that was not available to the owners of the bank, the rating agencies, and the buyers of securitized loans. It was able to set aside unrealistically low loan loss reserves even when the bank drastically lowered its credit standards that increased expected loan defaults. The low reserves for loan losses resulted in higher reported earnings and led to unwarranted higher compensation. This questionable practice leads to an agency problem to the detriment of bank owners and holders of securitized loan portfolios (Alonzi et al, 2010).

Recommendation 1 Act Provisions:

Subtitle E, Sec. 954(b)(2) of the Act provides that "in the event that the issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer with any financial reporting requirement under the securities laws, the issuer will recover from any current or former executive officer of the issuer who received incentive-based compensation (including stock options) during the 3-year period preceding the date on which the issuer is required to prepare an accounting restatement, based on erroneous data, in excess of what would have been paid to the executive officer under the accounting restatement."

On the surface this section appears to provide accountability in the form of a "claw back" penalty. However, the provision is ripe for broad interpretations which can conceivably eviscerate the intent of the section. To use an old adage, "you can drive a Mack truck through the penalty provisions of this section". It seems highly debatable that a calculation is even possible concerning the amount of compensation which is "in excess of what would have been paid to the executive … " The issue is whether a specific and identifiable amount of incentive compensation can be attributable to the "erroneous data." Also, the "3-year period preceding the date…of an accounting restatement" seems quite arbitrary.

While clearly there is an obvious intent to provide a "claw back" scheme, and while the claw back provision appears to have teeth, the Act does not really address underwriting risky loans. In other words, there is no disincentive to underwriting risky loans as long as the data is not "erroneous". Again, it is very difficult to prove that a banker or loan originator was intentionally using erroneous data.

This problem is exacerbated when loans are not warehoused in the bank's own loan portfolio. When bundled loans are securitized in the secondary markets, the risk of loan default is shifted to security holders, and this practice increases the risk of moral hazard. Alonzi et al's [2010] economic model of bank profit maximization " … revealed two significant effects created by the presence of asymmetric information concerning default risk. This asymmetry (1) could adversely impact the incentive effects of bank's reported earnings or (2) encourage the lowering of credit standards and the passing of increased default risk to non-bank investors through securitization of bundled loans."

Recommendation 2: Use of Longer Duration for Rewarding Bank Managers:

Requiring a longer duration before paying compensation. This approach ensures that managers are compensated only when cash repayment on loans occurs in the long run rather than loan volume produced in the current period. This practice reduces the likelihood of paying excessive compensation in the short run based on granting highly speculative loans.

Recommendation 2 Act Provisions: Not addressed by the Act.

Recommendation 3: Banks Forced to Limit Percentage of Loans Securitized in Secondary Market:

Since securitization shifts the default risk of loans completely to the investors who purchase the securities, if banks are limited by regulation to retain and hold in-house some mix of warehoused loans and resold loans, it may reduce the incentive to grant questionable loans. Whatever mix is chosen, compliance should be verified through the external audit process

Recommendation 3 Act Provisions: Not addressed by the Act.

Recommendation 4: Require Bank Investment in Loans Sold in the Secondary Market by Securitizer:

As noted above, the securitization process shifts the default risk from the banks to the owners of the securities backed by those loans. The banks should be mandated to invest in a percentage of those securitized loans proportional to the percentage of loans securitized. This will require them to have "skin in the game".

Recommendation 4 Act Provisions:

Title V Subtitle D of the Act authorizes the Securities and Exchange Commission (SEC) and Federal banking agencies within 270 days of the Act's enactment to "jointly prescribe regulations to require any securitizer (an issuer of an asset-backed security) to retain an economic interest in a portion of the credit risk. Section 941 (b) of the Act amends the Securities and Exchange Act of 1934 by adding a new Section 15G (c)(1) which requires a securitizer to retain not less than 5% of the credit risk. The new regulations will also address the allocation between the securitizer and the originator. The SEC has proposed regulations addressing this issue**.**

Two points are worth noting: First, the median prices of homes in regions of the U.S. as of March 2011 are as follows: Northeast: $236,500; Midwest: $126,300; South: $136,000; West: $196,000. Assuming a 90% loan for a home purchase (lenders may actually require more than a 10% down payment), the 5% credit retention ranges between $10,642 on a $212,850 loan in the Northeast to $5,670 on a $113,400 loan in the Midwest. These are not amounts that get the attention of loan originators or securitizers. Moreover, there will be exemptions from even this low retention amount for a "qualified residential mortgage" as determined by regulations promulgated by the SEC and Federal banking agencies based on "lower risk of default". These are the same agencies whose lax enforcement was a contributing factor to the banking meltdown in the first place. This is not a process that engenders a lot of confidence that agencies have the resources or the inclination to address the retention issue sufficiently. Moreover, the retention amounts are not exactly significant numbers that may catch the attention of loan originators or securitizers. In days past, when savings and loans were the primary home loan lenders, the S&L's carried the entire loan and the entire risk on their own books. There was far more scrutiny given not only to the quality of the loan, but also to the ability of borrowers to repay the loan.

Recommendation 5: Partial Recourse for Defaulted Securitized Loans:

Banks should be required to remain partially responsible for those loans that were securitized and end up in default. Partial recourse still leaves the securities investors vulnerable to some losses, but they should be responsible for neglecting the due diligence required to quantify the risk they undertake.

Recommendation 5 Act Provisions: Not addressed by the Act.

Recommendation 6: Institute Shareholder "Say-on-Pay" Policies:

"Say-on-pay" rules would allow stockholders to vote on executive compensation packages. This policy has proven effective in countries like the United Kingdom where it has limited egregious payouts at deeply troubled companies. It is possible that even with this rule in place, it may be very difficult to restrain overly generous corporate paydays.

Recommendation 6 Act Provisions:

Sec. 951 of Title E amends the Securities and Exchange Act of 1934 (15 U.S.C. 78a) by inserting a new provision entitled "Shareholder Approval of Executive Compensation," which reads in part as follows:

> "(1) Not less frequently than once every 3 years, a proxy or consent or authorization for an annual of other meeting of the shareholders ….shall include a separate resolution subject to shareholder vote to approve the compensation of executives … "
>
> (2) Not less frequently than once every 6 years, a proxy or consent or authorization for an annual of other meeting of the shareholders ….shall include a separate resolution subject to shareholder vote to determine whether votes on the resolutions required under paragraph (1) will occur every 1, 2 or 3 years."

This provision clearly addresses Alonzi et al (2010) Recommendation No. 6, "say on pay," by requiring corporations to provide its investors with a vote on executive officer compensation. This voting provision will provide management with information regarding shareholder sentiment on executive compensation and robs management of the excuse that there is inadequate proof of demand for changes in its financial remuneration. It also requires that financial firms with assets of $1 billion or more to disclose any incentive based compensation structures to federal regulators. In fact, this provision is toothless because the Act specifically states that the vote would be non-binding on the management. The Act also attempts to prevent the perverse compensation practices that motivate executives to undertake excessive business risk, at the expense of other stakeholders. These regulators will have the authority to void any inappropriate or risky compensation practices that pose a threat to the financial system or the broader economy. Note that there is no mention of fairness, justice, or equity for shareholders or employees. Federal regulators will intervene only in the extreme case of a potential economic meltdown.

Recommendation 7: Directors and Bank Management Should be Severely Scrutinized and Penalized, if necessary:

Macey and O'Hara [2003] recommended that directors and officers of banks should be charged with a heightened duty to ensure the safety and soundness of not only these enterprises but also the interests of other stakeholders like creditors, borrowers, secondary security market investors, employees, the financial system, and the public at large. If their self-interested actions have a deleterious effect on others, they should be penalized by forcing them to compensate the victims.

Recommendation 7 Act Provisions:

The Act created the CFPB, housed at the Federal Reserve, and whose mission is to protect consumers from unfair and abusive financial products and services, such as predatory mortgages. The CFPB will consolidate and strengthen consumer protection responsibilities currently under the supervision of the Office of the Comptroller of the Currency, Office of Thrift supervision ("OCC"), Federal Deposit Insurance Corporation, Federal Reserve, National Credit Union Administration, and Federal Trade Commission. It is led by an independent director appointed by the President, with a dedicated budget paid by the Federal Reserve Board which is not under the direct supervision of the Congress. The CFPB is intended to act as a watchdog to prevent another colossal economic meltdown. It will set basic safety standards on financial products. It will also prevent big banks from reaping excessive short run profits at the expense of working American families. It will possess the power to ban deceptive banking industry practices such as "teaser rates" and the use of misleading "fine print" to deceive mortgage holders by making the documentation fair and comprehensible.

With the intent of restoring confidence in the mortgage lending industry, it will create and enforce basic principles of sound lending, responsibility, and consumer protection. The CFPB will ensure that:

- Mortgage borrowers can repay the loans that they have undertaken (no penalty for or prohibition of early repayment).
- Irresponsible borrowers will no longer be allowed to prevaricate and obtain loans that they cannot repay.
- Mortgage lenders must make loans that benefit the consumer and are prohibited from steering borrowers into higher cost loans.
- The secondary mortgage bundlers are held responsible when they buy loans and turn them into securities.

The CFPB has the power autonomously to write rules for consumer protection governing all financial entities (banks and non-banks) that offer financial services or products to consumers.

It has the authority to examine and enforce regulations for banks with assets of over $10 billion and all mortgage related entities (lenders, servicers, mortgage brokers, collectors, and credit rating agencies). The CFPB is to accomplish the following:

- The ability to act fast and with agility to prevent bad deals and schemes that are detrimental to consumers without waiting for the notoriously slow Congress to pass laws.
- Create a new Office of Financial Literacy to educate consumers to become rationally informed economic actors.
- Create a national consumer complaint hotline which will enable consumers to use a single toll-free number to report problems with financial products and services.
- Work and coordinate with other regulators during bank examinations to prevent undue regulatory burden. It will consult with other regulators before a proposal is issued and they could appeal regulations if they believe that the proposal would negatively impact the safety and soundness of the banking system or the stability of the financial system at risk.

Penalties for violation of the Act

(1) Sec 1404(d)(2) of the Act amends sec. 129A of the Truth-In-Lending Act as follows:

"The maximum amount of any liability of a mortgage originator under paragraph (1) to a consumer for any violation of this section shall not exceed the greater of actual damage or an amount equal to 3 times the total amount of direct and indirect compensation or gain accruing to the mortgage originator in connection with the residential mortgage loan involved in the violation and costs to the consumer of the action, including reasonable attorney's fees."

While providing a penalty for violations to consumers, this provision is very narrow. It does nothing to address the broader issues stated in Recommendation 7. It will neither prevent nor penalize mortgage lenders from making risky loans.

(2) Sec. 1054(a), Litigation Authority, states that "If any person violates a Federal consumer financial law, the Bureau [CFPB], may … commence a civil action against such person to impose a civil penalty or to seek all appropriate legal and equitable relief, including a permanent or temporary injunction …"

(3) Sec. 1055(a)(2) provides the following possible relief for violations:

(A) rescission of contracts
(B) refund of moneys or return of property
(C) restitution
(D) disgorgement of compensation
(E) payment of damages
(F) public notification regarding violations
(G) limits on activities or functions of person
(H) civil penalties

(4) Sec. 1055(b) provides for "Recovery of Costs:"

"In any violations brought by the CFPB, a state Attorney General, or any state regulator to enforce any Federal consumer financial law, the CFPB, state Attorney General or the state regulator may recover costs in connection with prosecuting such action …"

(5) Sec. 1055(c)(2)(c) provides "Penalty Amounts:"

"(A) First Tier - for any violation of a Federal consumer financial law, $5,000 for each day the violation continues;
(B) Second tier - for any person that recklessly engages in a violation of a Federal consumer financial law, a civil penalty may not exceed $25,000 for each day the violation continues;
(C) For any person that knowingly violates a Federal consumer financial law, a civil penalty may not exceed $1,000,000 for each day the violation continues."

(6)Finally, Sec. 1056, "Referrals for Criminal Proceedings" provides "any person [who] has engaged in conduct that may constitute a violation of Federal criminal law, the CFPB shall transmit such evidence to the Attorney General of the United States who may institute criminal proceedings…"

The Act in Section 922 also created a whistleblower bounty program by encouraging whistleblowers to identify wrongdoing in the securities markets. This program will effectively lead to more "cops on the beat" in the securities markets. This provision may rein in malfeasance by banks, corporations, investment bankers, and rating agencies.

Recommendation 8: Changes in Financial Accounting Rule Setting and Practices:

One issue that needs to be addressed is whether accounting standards can serve a useful policy role in helping to shape bank executive behavior such that information asymmetry and moral hazard are eliminated or, at a minimum, sharply curtailed. Once it is understood that financial accounting standards have strong behavioral effects and economic consequences, this power should be wielded to create explicit accounting incentives as public policy tools. They should be used as a supplement to the direct subsidies, mandates, and tax incentives that are currently used by Congress to influence corporate behavior [Walker 2007, pg. 934]. Macey and O'Hara's [2003] argument regarding the potential beneficiaries of accounting rules can be used to recommend that U.S. financial accounting standards should be modified to protect the interests of other stakeholders in the firm and not just shareholders.

The SEC and/or the Financial Accounting Standards Board (FASB) should mandate that banks hire actuaries to determine loan portfolio risk in total and by some meaningful categorization of loans. The mortgage bank's risk profile should be highlighted in the notes to the audited financial statements. The risk estimation of securitized loans should not be left to just rating agencies, and the overall risk of banks should not be evaluated solely by auditors.

Recommendation 8 Act Provisions: Not addressed by the Act.

Recommendation 8B: Accounting Policy and Auditor Role:

The Madoff fraud made evident that the Public Company Accounting Oversight Board (PCAOB) does not have adequate powers needed to examine the auditors of broker-dealers. It also revealed that the Securities Investor Protection Act (SIPA) is deficient in enforcing the rule that money be returned to customers of insolvent fraudulent brokers-dealers. The same principles would apply to buyers of securitized mortgages

Recommendations 8B Act Provisions: Not addressed by the Act.

Recommendation 9: Changes in recognition of Bank Revenues to "As Loans Are Collected" Instead of "At Origination" Basis:

A bank's greatest risk and potential loss is that of loan default. The magnitude and certainty of this loss becomes clear only with the passage of time. To guard against the possibility of unduly compensating senior managers for bad loan decisions, banks should recognize revenues from originating loans over the life of the loan and not when cash is collected up front. There is precedence for this practice in financial accounting, for example, the revenue recognition rules for installment sales or revenue and expense recognition in the insurance industry.

Recommendation 9 Act Provisions: Not addressed by the Act.

Recommendation 10: Auditors should be Forced to Conduct Effective Audits, Through Penalties, if necessary:

Accounting regulators should assign some culpability to auditors of banks that suffer massive loan losses, unless the auditors had properly disclosed the relevant risks in their audit reports. Of course, the auditors should not be held culpable in cases of bank management fraud because auditors are not responsible for detecting fraud, *per se*. They should also not be held responsible for events that occur due to the systemic failures of the financial system.

Recommendation 10 Act Provisions: Not addressed by the Act.

CONCLUSION

Alonzi et al (2010) set out not only to identify some of the root causes of the financial crisis, but also to make concrete, specific recommendations designed to mitigate, at a minimum, if not eliminate some of the causes. It is clear that while the Act attempts to address causes of the mortgage banking crisis, it does not speak to all of the reasons for the financial meltdown. Moreover, even when the Act specifically tackles an issue, it often does so in a mediocre fashion. In short, the Act lacks sufficient teeth to dissuade aggressive mortgage lending practices.

The Act enhances the enforcement powers and funding of the SEC by doubling its authorized funding over five years. The passage of the Act has not deterred its opponents from attempting to defang and emasculate it. A New York Times report stated that Republicans, fearful of a public backlash that may be caused by a direct assault on the Act on behalf of the much maligned banks, plan to delay and disrupt the attempted reforms in the Act. The contemplated measures to derail the Act consist of: (1) cutting funding for regulatory agencies like the SEC and the Commodities Futures Trading Commission (CFTC) which would leave the agencies unable to enforce old and new rules; (2) denying the appointment of Ms. Elizabeth Warren, who was the godmother of the consumer financial protection movement, as the first executive director of the CFPB; and (3) unveiling several bills to dismantle the Act piece by piece by introducing rules that would be a recipe for delay and division (New York Times, March 27, 2011).

In summary, the Act does address some blatant past failings of mortgage lenders, yet fails to provide adequate powers or funding to prevent the malpractices. For instance, (1) the Act does not prevent incentive payments to mortgage originators based upon the number of loans originated of any quality, and (2) Adjustable Loan Mortgages (ARMs) and Nonstandard Loans are still permissible. Finally, the Act contains a significant “safe harbor” loophole permitting lenders to presume that a borrower has the ability to repay the loan.

REFERENCES

Alonzi, P. (2010). A Fine Financial Stew. *Financial Decisions*.

Alonzi, P., Irons, R. and Razaki, K. (2010). Asymmetric Information, Moral Hazard, and Agency Problems in Bank Lending. *Financial Decisions*.

Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203,H.R, 4173. (2010)

Macey, R.J. and M. O’Hara, 2003. The Corporate Governance of Banks. *FBNY Economic Policy Review.*

Marquand, Z. B. (March 2011) .Ability to Repay: Mortgage Lending Standards After Dodd-Frank. 15 North Carolina Banking Institute, 291,

United States Congress. HR 4173. The Wall Street Reform and Consumer Protection Act.

Walker, D. I. (2007). Financial Accounting and Corporate Behavior. 64,3 Washington and Lee Law Review.

McCoy, P.A., Pavlov, A.D. and Wachter, S. M. (2009). Systematic Risk Through Securitization: The Result of Deregulation and Regulatory Failure. 41 Conn. L. Rev. 493.

New York Times. (March 22, 2011). Who Will Rescue Financial Reform?