REGULATORY REFORM OF THE CREDIT MARKET: A SARBANES-OXLEY APPROACH

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ABSTRACT

The United States is in the midst of the worst credit crisis in the last 25 years. On July 31, 2008, President Bush signed into law the Housing and Economic Recovery Act (HERA), a new law aimed at dealing with this crisis. The Act created a new regulatory agency, the Federal Housing Finance Agency (FHFA), and it authorized spending billions of dollars to back up our credit market.

Business students and managers need to understand the legal environment of credit regulation. The purpose of this paper is first, to describe the current state of credit regulation and to explain how we arrived at the current crisis; and second, to propose regulatory solutions patterned after the Sarbanes-Oxley Act (SOX), which dealt with similar problems. The paper begins by reviewing the history of mortgage lending in the United States. It then examines predatory lending practices that have contributed to the crisis. Next, it reviews the current state of federal regulation, including the new FHFA. Finally the paper shows how the regulatory approach taken by the Sarbanes-Oxley Act can be used as a pattern to ease the current credit crisis and to improve mortgage lending practices.

INTRODUCTION

The United States is in the midst of the worst credit crisis in the last 25 years[1]. Federal Reserve Chairman Ben Bernanke described the financial crisis as a “gale force” that has created “one of the most challenging economic and policy environments in memory”[2]. The New York Times recently reported that “across the United States, neighborhoods are littered with an estimated 900,000 vacant homes, the result of foreclosures, bank repossessions and abandonment”[3]. The Wall Street Journal recently estimated that “at least $2.7 trillion has been wiped off the market value of European and U.S. Banks, insurers and asset managers”[4]. Earlier in 2008 the Federal Reserve engineered a bailout of the Wall Street investment firm of Bear Stearns, which might cost taxpayers $30 billion[5].

Congress reacted to this crisis on July 31, 2008 by enacting the Housing and Economic Recovery Act[6] (HERA), the most comprehensive (and potentially the most expensive) bailout of the mortgage lending industry in history. HERA authorized the Federal Housing Administration[7] (FHA) to insure up to $300 billion in refinanced mortgages; it created a new regulatory agency, the Federal Housing Finance Agency[8] (FHFA) to regulate the mortgage giants Fannie Mae and Freddie Mac; and it authorized the Treasury Department to pump an unlimited amount of money into Fannie Mae and Freddie Mac to prevent their collapse[9].

This mortgage-driven credit crisis presents legal, ethical and regulatory issues. Lawmakers and others are assessing whether the Federal Housing Finance Agency[10] (FHFA), the new regulatory agency created to oversee Fannie Mae and Freddie Mac, is enough to deal with the crisis and its underlying causes. FHFA deals with problems relating to securitized subprime mortgages, but it does not address problems related to mortgage origination, such as predatory lending. Unfortunately legal safeguards such as the Truth in Lending Act[11] (TILA) have not been sufficient to prevent such practices.

This paper will help business students and managers better understand the current crisis in our credit markets. First it will review the history of mortgage lending in the U.S. Then it will examine the more recent phenomenon of securitization, in which home mortgages were pooled, bundled, formed into securities and then sold to investors. Next, predatory lending practices will be described and considered. Current federal regulation will then be discussed, including the new FHFA. Finally, the paper will show how the lessons of the Sarbanes-Oxley Act[12] (SOX) can be applied to the subprime mortgage crisis. SOX dealt with problems in public accounting and corporate governance that in many ways are analogous to the problems that led to the current credit crisis. Among these are failure to exercise due diligence, conflict of interest, and violation of fiduciary duties.

HISTORY OF MORTGAGE LENDING IN THE U.S.

Mortgage lending in the nineteenth century in the U.S. was a relatively simple affair. Typically, small groups of friends and neighbors formed "building societies"[13]. Members agreed to make weekly contributions to a building fund. These funds were used to pay for the construction of one house at a time until each member owned a house. At that point the building society would be disbanded. Toward the end of the nineteenth century these building societies evolved into organizations that were run by professional managers. These organizations were often called "building and loan" companies. They accepted savings deposits, paid interest, made mortgage loans, and they did not plan to disband. These organizations are now called "savings and loans" or "thrifts"[14] and they provide other credit services in addition to mortgages.

In the late nineteenth and early twentieth centuries commercial banks generally did not make home mortgage loans. They were concerned about risk and about committing their funds for long periods. This void was filled by thrifts, as noted above, and also by the emergence of savings banks, private mortgage companies, and insurance companies[15]. However, during this period only relatively affluent people could obtain a mortgage and thereby acquire a home. Mortgage down payments were typically forty percent and mortgage loans averaged three to six years[16].

The mortgage market was radically changed by the Great Depression which began in 1929. The nation experienced the horrors of deflation: demand for goods, services and real estate all dropped, and prices fell. With a national unemployment rate of 25 percent, and both personal and business bankruptcies at record levels, half of all single-family mortgages fell into default[17]. Banks that had made these mortgage loans suffered large losses, because the prices obtained at foreclosure sales often did not cover the outstanding loan balances. As a result, banks, thrifts, and mortgage companies were unwilling to make new mortgage loans in most cases. Without the availability of mortgage financing, new home construction ground to a halt. The demand for lumber, materials, construction labor, and appliances shrank, further exacerbating the economic depression.

The first federal response to the mortgage crisis during the depression came during the administration of President Herbert Hoover. Congress created twelve regional Federal Home Loan Banks (FHLBs)[18]. The FHLBs loaned money to the thrifts at low interest rates. With this new capital, the thrifts started to issue new mortgages.

The Federal Home Loan Banks helped, but they did not solve the problem. Lenders were still fearful of suffering loan losses associated with foreclosure. After President Franklin Roosevelt was elected in 1932, he pressed for more aggressive measures. In 1934 Congress created the Federal

Housing Administration[19] (FHA), which remains an important agency today. The FHA solved the problem of banks' fear of mortgage loan losses by providing insurance to lenders so that if the proceeds of a foreclosure sale did not cover the loan balance, the federal government would make up the difference[20]. This made the loan risk-free to the lender. Also, FHA insurance allowed lenders to issue mortgages of much longer duration – up to thirty years, and with as low as twenty percent down payments. This opened up the mortgage market to many more borrowers, stimulating the banking and construction industries, and providing a boost to the economy.

The Roosevelt administration pressed Congress for additional reforms. In 1938 Congress created another important agency that has been instrumental in providing mortgage credit, although its future is less certain today. This was the Federal National Mortgage Association (FNMA), known as "Fannie Mae"[21]. Fannie Mae did more than insure mortgages; it purchased mortgage loans that had been insured by FHA. These FHA-insured loans were termed "nonconventional" because of their insured nature. In this way Fannie Mae provided a secondary market for FHA-insured mortgages, allowing a lender to quickly sell the mortgage and recover its principal, plus profit, which could then be lent out again to another borrower.

At this point lenders could (if they complied with FHA standards) issue loans with no risk of loss, and then quickly transfer the loan while retaining the fees and profit associated with the loan. It quickly became obvious that this was a great opportunity for lenders and many new mortgage companies, insurance companies, and even some commercial banks took advantage of the opportunity. After World War II the Veterans Administration offered VA guaranteed loans that Fannie Mae also bought. The returning veterans were anxious to make up for lost time; they began the "baby boom" and wanted homes. With demand high, and mortgage credit relatively easy to obtain, a construction and housing boom ensued. This helped to avoid a post-war recession like the one that had followed World War I.

The next major development in the mortgage market came in 1968. Fannie Mae had provided a secondary market for FHA insured mortgages, but it would not purchase conventional, uninsured mortgages. Mortgage companies pressed Congress for an agency that would provide a secondary market for conventional (uninsured) mortgages. The legislative response was to split Fannie Mae into two separate agencies: the Government National Mortgage Association, known as "Ginnie Mae", and another agency that retained the old name of Fannie Mae. Ginnie Mae operated the same way that the old Fannie Mae had: purchasing nonconventional, government insured mortgages. The new Fannie Mae became a private, federally chartered corporation. Its mission was to purchase conventional, uninsured mortgages, thus providing a secondary market for them[22]. Almost immediately, the modern era of securitized mortgages began.

THE SECURITIZATION REVOLUTION

With both conventional and nonconventional mortgages enjoying the liquidity of a robust secondary market, both Ginnie Mae and Fannie Mae began creating and selling a new form of security: it consisted of a large number of diversified mortgages, from different parts of the country that formed a "pool". Investors here and around the world could purchase an income stream from a share of the securitized mortgage pool[23]. The mortgages were FHA or VA insured or guaranteed by the "new" Fannie Mae, which was a government sponsored enterprise (GSE). Although the federal government did not explicitly guarantee the new Fannie Mae securities, investors assumed that the government would not allow Fannie to fail. Its mortgage-backed securities seemed a safe, attractive investment. Substantial amounts of new capital became available to mortgage borrowers.

These new mortgage-backed securities were popular with investors. However, the government sponsored enterprises (GSEs) would only purchase "prime" mortgages. Prime mortgages qualify to be resold to Fannie Mae or to another GSE. They use standard documentation, meet uniform underwriting standards, and are sold for similar prices. Subprime mortgages, in contrast, include "innovations"[24] such as adjustable interest rates, low down payments or zero down payments, interest-only mortgages, and home equity loans, as well as mortgages in which the borrower has a low credit score. These subprime mortgages could not be securitized by the GSEs. Banks and investment firms realized that if these subprime mortgages could be securitized, a large and profitable new market would be opened up.

The movement by banks and investment firms toward securitization of subprime mortgages began in 1977. Bank of America and the investment bank firm of Salomon Brothers began issuing mortgage backed securities. Because these securities were not issued by a GSE, they were called "private label" [25] mortgage-backed securities. Now, for the first time, securities investors could purchase income streams from mortgages that were not acceptable to, or backed by the GSEs. This presented a problem: while some investors were happy to purchase riskier securities that provided a higher return, it was difficult to assess the level of risk and therefore the correct price for those securities.

This problem was finally solved in the early 1990s through the use of mathematical models that predicted the level of risk. Rating agencies like Standard and Poor's applied the models, rated the securities, and they were priced accordingly. Investors with higher risk tolerance were able to purchase mortgage-backed securities that matched their risk/reward preferences. Banks, investment firms, and mortgage brokers all made substantial profits. For example, between 2004 and 2006 the dollar volume of interest-only mortgages and adjustable rate mortgages increased from $205 billion to $775 billion[26]. It seemed like a new golden age in real estate finance, until it all began to unravel. One of the causes for the unraveling was predatory lending.

THE ROLE OF PREDATORY LENDING IN THE MORTGAGE CRISIS

As we have seen, private label securitization made huge amounts of capital in the securities markets available to subprime lenders. In order to take full advantage of this opportunity, lenders began aggressively marketing to subprime mortgage borrowers. This created fertile ground for predatory lending practices.

Some may doubt that predatory lending exists, or that it is prevalent. Consider the testimony of Mary Podelco in a 2001 hearing before the Senate Committee on Banking, Housing, and Urban Affairs:

> I grew up in West Virginia and went though the 6th grade … In 1987, my husband Richard and I were very proud that we were finally able to purchase our own small home. He worked as a maintenance worker and passed away in June 1994. I became the sole owner. In July 1994, I paid off the $19,000 owed on the home from the insurance from my husband's death. Before my husband's death, I never had a checking account or a credit card. I had always paid my bills in cash and tried to be an upstanding responsible citizen…
>
> In 1995 I received a letter from Beneficial Finance offering to lend me money to do home improvements. I thought it was a good idea to put some new windows and a new heating system in my home. I signed a loan with Beneficial in May 1995 … My monthly income at that time was $458 from Social Security and my payments were more than half of this. They took a loan on my house of about $11,921. The very next month, Beneficial talked me into refinancing the home loan for $16,256. I did not understand that every time I did a new loan, I was being charged a bunch of fees.

I began getting calls from people trying to refinance my mortgage all hours of the day and night. I received a letter from United Companies Lending telling me that I could save money by paying off the Beneficial loan. On September 28, 1995, I signed papers in their office. More fees were added and the loan went to $24,300, at an interest rate of 13.5 percent. Just a few months later, I received a letter from Beneficial telling me I could save money by paying off United and going back to Beneficial …

In February, 1996, Beneficial advised me that it was time for me to refinance again. The loan papers show that I was charged a finance charge of $18,192 plus other fees and an interest rate of 14 percent. By the end of February, I had five different loans in 10 months. I did not understand that they were adding a lot of charges each time. After that I was called by Equity One by telephone to refinance … On May 28, 1996 I signed papers with Equity One … which … increased my total loan from $45,000 to over $64,000. I got $21.70 cash out of the loan … Then on June 13, Equity One suggested that I needed another loan to pay off a side debt and they loaned me $1,960 at over 26 percent interest …

Then on August 13, Equity One started me on another loan … to help me by lowering my payments. This loan included $2,770 in new fees and costs … The payments were still too much. I missed my first payment … in December 1996 … They would not take a late payment from me unless I made up for the missed payment. I could not do it. Later in 1997, I lost my home to foreclosure …[27]

Further evidence of predatory lending comes from the training given to some finance company loan officers. One such former employee, testifying anonymously in 1998 before the Senate Special Committee on Aging explained:

Finance companies try to do business with blue-collar workers, people who have not gone to college, older people who are on fixed incomes, non English-speaking people, and people who have significant equity in their homes. In fact, my perfect customer would be an uneducated widow who is on a fixed income, hopefully from her deceased husband's pension and Social Security, who has her house paid off …

To flip a … home equity loan, we were trained to sell the monthly "savings" – that is how much less per month the customer would be paying off if we flipped the loan. In reality, the "savings" that we were trained to sell to the customers were just an illusion. The uneducated customer would jump for the "savings", thinking that he would have more money to buy other things. What the customer would not figure out, and what we would not tell him, is that he would be paying for a longer period of time and, in the end, would pay a whole lot more. [28]

While there is no definitive statutory definition of "predatory lending", it is generally understood to include "extending credit without regard to the borrower's ability to repay"[29]. This definition would include many subprime loans. Eleven different federal agencies, under both Republican and Democratic administrations, have used the term "predatory" to describe harsh terms and behavior in credit markets[30].

In their zeal to issue subprime loans in order to take advantage of the profit opportunities that private label securitization presented, loan officers often issued subprime loans even to borrowers who qualified for prime loans. In 2004 Federal Reserve Board Governor Edward M. Gramlich stated: "Borrowers with FICO (credit) scores below 620 are viewed as higher risk and generally are ineligible for prime loans … But it is noteworthy that about half of subprime borrowers have FICO scores above this threshold, indicating that a good credit history alone does not guarantee prime status."[31] Research by Freddie Mac (another GSE) reports that as many as 35 percent of borrowers in the subprime market could qualify for prime market loans[32].

Countrywide is the largest mortgage lender in the United States. The L.A. Times reported on November 20, 2004, that in a memo a vice president at Countrywide "encouraged loan officers … to downgrade borrowers' credit ratings in order to steer them into more expensive loans". The memo went on to list five ways to steer borrowers into the subprime category, including listing only one income in a two wage earner family, increasing the amount of the loan, and not listing any of the borrower's assets[33].

Even mortgage borrowers with excellent credit scores are at the mercy of unscrupulous loan officers who may add redundant or unnecessary fees. These additional fees will not be noticed if the mortgage is prime and carries a relatively low interest rate. Even relatively knowledgeable borrowers may be overwhelmed by the many forms and documents that must be dealt with at a real estate closing. Often the closing on the house purchase and the closing on the mortgage occur simultaneously. Everyone who has been through this process will recall the enormous amount of paperwork and signing that takes place.

FEDERAL REGULATION OF MORTGAGE LENDING

The most important federal regulatory statute affecting the credit market is the Truth in Lending Act[34] (TILA) of 1968. Prior to the TILA lenders used many different methods to calculate the stated interest charge. Lender A might state an interest charge of 10 percent, while lender B stated an interest rate of 12 percent, but the cost of lender B's loan might be lower. This would be true if lender A charged numerous fees in addition to the interest charge. In order to allow consumers to make an "apples to apples" comparison, the TILA created an "annual percentage rate" (APR) that lenders were required to use[35]. The APR must be conspicuously displayed in the loan contract. Another term that must be conspicuously displayed is the "finance charge"[36]. The finance charge is intended to reveal the total cost of the loan; that is, its interest charge plus fees. The finance charge is extremely important because it is used to calculate the APR. The APR is simply the finance charge calculated on an annual basis.

The centrality of the finance charge makes it imperative that this amount accurately reflect the true total cost of the loan. It must also be uniformly calculated by all lenders, in order to serve the basic purpose of the TILA to provide consumers with a simple method to compare loan costs. Unfortunately, the integrity of the finance charge, and therefore of the APR, has been undermined. This is a result of the TILA itself, and also because of action of the Federal Reserve Board. First, the TILA itself provides for a limited number of exceptions: excluded charges that do not need to be disclosed or included in the stated finance charge[37]. These include fees for property surveys, document preparation, appraisals, credit reports, notary fees, escrow fees, and insurance paid in lieu of perfecting a security interest.

Second, the TILA gave the Federal Reserve Board authority to create additional exceptions, where "necessary or proper to effectuate the purposes of the Truth in Lending Act"[38]. The Federal Reserve Board issued Regulation Z, which created additional exceptions to the finance charge. Regulation Z added late fees, credit application fees, charges for exceeding a credit limit, and annual or periodic fees to participate in a credit plan for loans that did not have a fixed term.

Here is a recent example of how these fees can distort the true cost of credit: in the 2007 case of Pennsylvania Department of Banking v. NCAS of Delaware[39], a lender described a loan as charging interest at 5.98 percent, with an APR of 6 percent. However, this loan included a monthly participation fee of $149.50. If the participation fee (excluded from the stated finance charge by Regulation Z) had been included in the APR, the APR would have been 400 percent.

The Federal Reserve Board created still more exceptions - charges that did not need to be included in the finance charge - through official staff responses to lender inquiries. Since 1981, these responses have been known as "Official Staff Commentary". These exceptions include credit report fees and participation fees even for fixed term loans like mortgages[40]. These exceptions to the finance charge undermine the effectiveness of the APR. As Senator William Proxmire, one of the main proponents of the TILA, said in 1967:

> A third principle is that the definition of the finance charge, upon which an annual percentage rate is calculated, needs to be comprehensive and uniform. It needs to be uniform to permit a meaningful comparison between alternative sources of credit … The definition of the finance charge also needs to be comprehensive in order to convey the true cost of credit.[41]

Two other federal regulatory statutes which attempt to deal with predatory mortgage lending are the Real Estate Settlement Procedures Act[42] (RESPA) of 1974, and the Home Ownership and Equity Protection Act[43] (HOEPA) of 1994.

RESPA was an attempt to give mortgage borrowers information that would inform them of their loan's closing costs. It requires disclosure of all discount points, real estate agent fees, loan broker fees and other closing costs. The lender or mortgage broker must give the borrower a "good faith estimate" of closing costs within three business days after applying for a mortgage. The lender or mortgage broker must also give the borrower an informational pamphlet that describes closing costs. This pamphlet must also be provided within three days. However, RESPA does not require that the actual closing costs conform to the "good faith estimate", and it is questionable whether at the closing, (which as noted above involves a blizzard of paperwork and signing) many borrowers will go through a line-by-line comparison of the estimate and the statement of final closing costs. Perhaps RESPA's most useful contribution to borrower protection is its prohibition of kickbacks and referral fees[44].

HOEPA addresses predatory mortgage lending more directly than RESPA. Many practices are prohibited, but only if the mortgage loan falls into the category of a "high cost"[45] mortgage. Two "triggers" will determine whether the loan is high cost, and therefore regulated by HOEPA. The first is if the interest rate is greater than a certain amount; the second is if the points and fees associated with closing the loan exceed a certain amount. These two triggers are described in 15 U.S.C. Sec. 1602(aa)(1):

> (A) the annual percentage rate at consummation of the transaction will exceed by more than 10 percentage points the yield on Treasury securities having comparable periods of maturity on the fifteenth day of the month immediately preceding the month in which the application for the extension of credit is received by the creditor; or
> (B) the total points and fees payable by the consumer at or before closing will exceed the greater of--
> (i) 8 percent of the total loan amount; or
> (ii) $400.

Several factors conspire to weaken the effectiveness of HOEPA. First, mortgage lenders can price their loans just under the trigger points. Second, this Act does not apply to first mortgages obtained to finance the original purchase of a home. It applies primarily to second mortgages and to home equity loans. A Treasury Department report in 2000 revealed that "from July through September 1999, only 0.7 percent of all subprime loans would be covered by HOEPA"[46].

However, where it does apply, HOEPA usefully outlaws many predatory practices. For example, in cases where the monthly payments are greater than half the borrower's gross monthly income, pre-payment penalties are forbidden. Lenders are prohibited from making loans based on the borrower's collateral (equity in her home) rather than on her income. Lenders are prohibited from adding penalty interest rate increases based on late payments. Special warnings and disclosures are required. The lender must warn that the borrower could lose her home if she fails to make timely payments. At least three days prior to closing the loan, the borrower must be notified that it is not too late to back out of the transaction. Within that time the lender must disclose the annual percentage rate, the cost of any credit insurance charges, and any balloon payments[47].

THE NEW FEDERAL HOUSING FINANCE AGENCY

As noted in the introduction, on July 31, 2008 President Bush signed into law a massive housing bail-out statute, the Housing and Economic Recovery Act (HERA), intended to deal with the subprime lending crisis. HERA contains ten major sections (Titles). Title I, "Reform of Regulation of Enterprises" created a new federal regulatory agency, the Federal Housing Finance Agency (FHFA) with authority to oversee the operations of government sponsored enterprises (GSEs) including Fannie Mae and Freddie Mac. These GSEs own or insure over half of the home mortgage debt in the United States. There is concern that if these GSEs were to fail, it would destabilize the U.S. and perhaps the global credit markets[48].

HERA's nine other Titles attempt to deal with the subprime home loan crisis by establishing a requirement of licensing and registration of mortgage loan originators[49]; a plan to refinance $300 billion in distressed loans through the Federal Housing Authority (FHA); a tax credit of up to $7,500 for first time home buyers; and authority for the Treasury Department to rescue Fannie Mae and other GSEs by injecting an unlimited amount of capital[50], if necessary. HERA raised the national debt ceiling by $800 billion[51] in order to assure that, if needed, adequate funds would be available to bail out the GSEs. In addition, there were tax breaks and incentives for businesses, home builders, veterans, homeless persons and minorities.

The new Federal Housing Finance Agency (FHFA), created to oversee the operations of Fannie Mae and other GSEs is described as "an independent agency of the federal government"[52]. This is important for two reasons. First, the agency is independent, not dependent. This means that the Director will serve a fixed term, and not at the pleasure of the President. He or she can only be removed "for cause", which would be misconduct or incapacity. Second, it established that the agency is a unit of the United States government.

The Director's term is set at five years. Section 1102 describes his/her duties as "(A) to oversee the prudential operations of each regulated entity; and (B) to ensure that … each regulated entity operates in a safe and sound manner, including maintenance of adequate capital and internal controls …".

HERA Section 1103 establishes the Federal Housing Finance Oversight Board. This high-powered Board "shall advise the Director" but "may not exercise any executive authority". The Board is comprised of four members: the Secretary of the Treasury, the Secretary of Housing and Urban Development, the Chairman of the Securities and Exchange Commission, and the Director, "who shall serve as the Chairperson of the Board". Section 1118 requires the Director to "consult with and consider the views of the Chairman of the Board of Governors of the Federal Reserve System … prior to issuing any proposed or final regulations, orders and guidelines … also shall consult with the Chairman regarding any decision to place a regulated entity into conservatorship or receivership".

In order to be effective, any regulatory agency must have "teeth" to enforce its regulations. These consist of civil and criminal penalties for violations. Section 1155 describes the civil penalties that FHFA can impose.

FHFA's civil penalties are described as falling into one of three "Tiers". Tier Three, the most serious, provides a civil penalty of up to $2 million per day for each day during which a violation occurs. Tier Three violations consist of intentional, knowing misconduct. Any mortgage lender or lending officer who "knowingly … engages in any unsafe or unsound practice in conducting the affairs of the regulated entity; or breaches any fiduciary duty; and knowingly or recklessly causes substantial loss to the regulated entity or a substantial pecuniary gain …" can be liable for a Tier Three penalty.

Tier Two violations provide a penalty of up to $50,000 per day. These violations involve less egregious conduct and less financial damage. To be liable for a Tier Two violation, a party must have acted "recklessly", or perhaps negligently (but not intentionally) in a "pattern of misconduct" that "causes or is likely to cause more than a minimal loss to the regulated entity".

Tier One violations can result in civil penalties up to $10,000 per day for each day the violation continues. These penalties may be imposed for violations of Title I of HERA or of regulations promulgated by FHFA. There is no requirement that the violation must be intentional, or reckless, or that financial loss must result, or that a pattern of violations exists. Even one negligent act can result in a Tier One violation.

Criminal penalties are described in Section 1156. They are less nuanced than the civil penalties described above. There are no Tiers. Section 1156 simply provides for imprisonment for up to five years, and a fine of up to $1 million. Criminal liability is triggered when a person who is subject to an order by FHFA knowingly violates that order.

It is, of course, far too early to assess the effectiveness of FHFA, or of the other provisions of the Housing and Economic Recovery Act (HERA) of 2008. The Director of FHFA has broad discretionary authority to promulgate regulations that cause the GSEs to operate "in a safe and sound manner". Whether this discretion will be exercised vigorously or cautiously will depend, to a certain extent, upon the President of the United States, who will appoint the Director.

The next section of this paper will propose a new regulatory approach inspired by the Sarbanes-Oxley Act[53] (SOX) of 2002. Although SOX dealt with an earlier financial crisis, many of the underlying problems are the same as in the current credit crisis: failure to exercise due diligence, conflict of interest, and breach of fiduciary duties.

A SARBANES-OXLEY APPROACH TO CREDIT REGULATION

The Sarbanes-Oxley Act (SOX) was enacted in response to massive corporate failures, including Enron, Tyco, and WorldCom, due in part to the failure of public accounting firms like Arthur Anderson to assure the reliability of financial information. A crisis in investor confidence ensued, with losses estimated at between $300 billion[54] and $460 billion[55]. Today we face a crisis of confidence in the credit markets, with losses estimated at over $2.7 trillion[56]. Every week the financial press seems to report additional losses. Many of the underlying problems that led to SOX are similar to those that led to the credit crisis today. Therefore, I propose a regulatory approach to the credit crisis that is similar to the approach taken by SOX. Below I will discuss the similarities and I will propose regulatory solutions using a SOX approach.

Due Diligence

One of the causes of the financial meltdown of Enron, Tyco and others that led to the Sarbanes-Oxley Act was the failure of auditors to exercise due diligence: to be sufficiently thorough or aggressive in certifying the reliability of corporate financial information. This allowed corporations to get away with "cooking the books", overstating their profits and understating their liabilities. When the truth came out, precipitous drops in stock prices wiped out billions of dollars, and investor confidence in our securities market was shaken.

There were several reasons for these softball audits. One was that the same accounting firm that conducted the audit was also providing consulting services to the corporation. These consulting services were often more profitable, and they generated more fees, than the audit services. For example Arthur Anderson, Enron's auditor, earned $29 million annually from consulting fees compared with $21 million annually from auditing fees[57]. Accounting firms not wanting to jeopardize their lucrative consulting work were less aggressive and thorough in their audits.

SOX addressed this problem in several ways: first, it prohibited accounting firms from doing most non-audit work for corporations that the accounting firm was also auditing. SOX Section 201 specifically prohibits an accounting firm that is conducting an audit of a public corporation from providing bookkeeping, appraisal, management consulting, human resources, legal services and other services[58].

Second, SOX created a new regulatory agency for public accounting, the Public Company Accounting Oversight Board[59] (PCAOB). The Board enforces the exercise of due diligence through a system of inspections and investigations. In effect, the PCAOB audits the auditors. At least once every three years an inspection team visits an accounting firm that conducts up to 100 audits of public companies. If the auditors conduct more than 100 per year they are inspected annually[60]. The PCAOB inspection team consists of experienced auditors, who have worked at least five years in this field. They review a sample of audits. If they find irregularities or violations, then an investigation may ensue. The investigators, armed with subpoena power, take a more prosecutorial approach. Substantial civil and criminal penalties can be imposed. The PCAOB can also terminate an accounting firm's right to engage in public company auditing[61].

Lack of due diligence also played an important role in the current credit crisis. Mortgage originators (brokers and lenders) had the ability to maximize their compensation by originating as many mortgages as possible. Traditionally, this had been tempered by the lenders' concern over loan repayment (credit risk). But following the securitization explosion of the 1990s, most mortgages were quickly resold in the secondary market. Loan originators thus relieved themselves of credit risk. If there was a default, it was no longer their problem. Loan originators therefore relaxed their lending standards just as accounting firms doing consulting work had relaxed their audit standards and vigilance. The result was a tremendous increase in subprime and other "innovative" mortgages that contained high credit risk.

A Sarbanes-Oxley approach to this problem would be to create a new regulatory agency with powers similar to those of the PCAOB. Let's call this new agency the Mortgage Origination Oversight Board (MOOB). Like all regulatory agencies, MOOB would promulgate rules and standards; these would promote sound lending practices. MOOB would then enforce its rules with periodic inspections and investigations. MOOB could also enforce the Truth in Lending Act (TILA) as it relates to mortgages. It might choose to reinforce the TILA with regulations that more forcefully deter predatory mortgage lending. Inspectors who were experienced mortgage professionals would conduct periodic inspections of all mortgage originators to assure compliance with those rules and standards. Irregularities or violations would trigger an investigation, which could result in civil or criminal fines and even jail sentences for willful, intentional misconduct.

All mortgage originators would be required to register with MOOB, just as all public accounting firms must register with the PCAOB. Registration would be a prerequisite to engaging in the business of mortgage origination. A bank, thrift, mortgage company, or other originator's registration could be revoked by MOOB, removing that firm from the industry. Like the PCAOB created by SOX, MOOB could be self-funding. The PCAOB obtains its funds from a small fee levied on public companies[62]. MOOB could obtain its funds from a small fee imposed on all mortgages or on all securities backed by mortgages.

An agency like MOOB would have powers far in excess of the new Federal Housing Finance Agency (FHFA) created by the Housing and Economic Recovery Act (HERA) of 2008. FHFA's regulatory authority is limited to oversight of Fannie Mae and other GSEs. It has no jurisdiction over the mortgage origination process. MOOB would represent a major increase in the level of federal regulation of the mortgage market. It would, no doubt, face stiff opposition from the industry.

Conflict of Interest

Another cause of the financial melt-down of 2000-2001 was that some securities analysts wrote biased reports on new issues of securities that were being sold by the investment banks that employed the analysts. SOX Section 501 addressed that problem. It does not forbid an analyst from reporting on securities being sold by her firm, but it mandates a "wall of separation" between the departments within the firm that deals with sale of new issues and those that write reports. Section 501(a)(1)(B) requires that "supervision and compensatory evaluation of securities analysts" must not be done by persons engaged in sales. Section 501(a)(1)(C) goes on to prohibit retaliation within the investment firm against an analyst who writes "an adverse, negative, or otherwise unfavorable research report".

Investors rely on ratings firms like Standard and Poor's to provide ratings of debt securities in order to assess their risk, and therefore the price investors are willing to pay. We have already seen how securitization revolutionized mortgage lending by infusing huge amounts of capital into the secondary mortgage market. Private label securitization, discussed above, involved the issuance of mortgage-backed securities by private issuers, as opposed to the government sponsored enterprises (GSEs) like Fannie Mae. Investors assumed that the federal government backed the GSEs, so their mortgage-backed securities were considered relatively risk free. However, mortgage-backed securities issued by private investment firms like Salomon Brothers were not backed by the government, so their risk was higher. How much higher was an important question, as it would affect the price paid by investors. Rating agencies like Standard and Poor's answered this question for investors. Using complex mathematical formulas the ratings agencies made their determinations, generally assigning a low risk to those securities. When those ratings proved to be overly optimistic, prices fell precipitously, causing great loss to investors and the collapse of several investment firms, most famously Bear Stearns.

The problem of overly optimistic ratings of mortgage-backed securities by rating firms is closely analogous to the problem of overly optimistic reports by securities analysts prior to Sarbanes-Oxley. In both cases the authors had a financial interest in issuing positive ratings or reports. Ratings firms were compensated by the firms issuing the securities, and analysts were compensated by their own firms, who were issuing the securities. In both cases there were opportunities for pressure to be brought on those writing the reports or determining the ratings.

A Sarbanes-Oxley approach to this problem of rating agency bias would be to provide more independence to the professionals making ratings determinations, just as SOX Sec. 501 provides more independence to securities analysts. This could be accomplished in much the same way as in Sec. 501. The professional staff determining ratings could be protected by a “wall of separation” within the ratings firm, and retaliation against the author of a negative or unfavorable rating could be prohibited.

Recent behavioral research indicates that even if there are no overt threats or inducements, people tend to develop subconscious biases that favor their interests[63]. A potential solution to the problem of ratings bias would be to sever the compensation link between the mortgage-backed securities issuers and the ratings firms. Compensation for providing ratings could be paid, for example, from a small fee added to the cost of the securities. In this way the investors who purchased the securities would pay the fee, avoiding the problem of subconscious bias and reinforcing the obligation of the ratings firms to the ultimate users of that information - the investors.

Another conflict of interest problem addressed by SOX was the “cozy” relations that developed between auditors and their corporate clients after many years. Audit firm partners and corporate CEOs often became personal friends, making tough, objective audits more difficult. SOX attempts to remedy this problem in Section 203, which mandates rotating the “lead (or coordinating) audit partner having primary responsibility for the audit” at least every five years[64]. A tougher requirement would have been to require rotation of audit firms every five years, but SOX backed off that more radical requirement. However, SOX was aware that rotation of the lead audit partner might not be sufficient; in Sec. 207 SOX ordered the Comptroller General of the United States to prepare a report that would provide a “review of the potential effects of requiring mandatory rotation of registered public accounting firms”.

This Sarbanes-Oxley approach could be applied to the securitized mortgage area by requiring rotation of ratings firms every five years. Ratings firms would know that if they had been too generous in their ratings, this would probably be discovered by the next ratings firm that reviewed those securities.

Breach of Fiduciary Duty

Breach of fiduciary duty was a problem addressed by the Sarbanes-Oxley Act. Chief Financial Officers (CFOs) and Chief Executive Officers (CEOs) are agents who owe a fiduciary duty to their corporations and to stockholders[65]. This requires utmost loyalty, as well as due diligence. In order to reinforce corporate managers’ compliance with this duty, SOX Sec. 302 requires that CFOs and CEOs sign the periodic reports submitted to the Securities and Exchange Commission. In signing, these managers must certify that:

(1) the signing officer has reviewed the report;
(2) based on the officer’s knowledge, the report does not contain any untrue statement of a material fact …
(3) based on such officer’s knowledge, the financial statements … fairly represent the financial condition … of the issuer[66]

Mortgage originators owe a fiduciary duty to their customers, the borrowers. Nevertheless, we have seen that in their zeal to issue as many mortgages as possible, many originators ignored the credit-worthiness of their customers and issued subprime and other “innovative” mortgages that contained a high risk of default. Default damages the borrower in many ways. A SOX approach to this problem would be to require the person originating the loan to sign a statement that based on his or her knowledge the mortgage loan is in compliance with sound lending practices and standards, as established by an agency like MOOB. In addition, the CFOs and CEOs of mortgage firms could be required to follow the example of SOX and be required to sign the periodic reports filed with regulatory agencies.

Another approach taken by SOX is contained in Section 404, which requires that public companies establish strong internal controls. Internal controls allow accountants to detect improper financial flows within the firm. They often provide the first warning of improper conduct. This requirement could be usefully applied to mortgage origination firms and also to investment firms that securitize mortgages. It should be recognized, however, that SOX Section 404 has attracted more criticism than any other section of the Sarbanes-Oxley Act, because it imposes a significant increase in auditing cost on public corporations[67]. Strong opposition to an internal control requirement can be expected from the mortgage industry.

CONCLUSION

If an American home buyer from 1850 could be transported to today, she would see a totally transformed credit landscape. Instead of the small groups of friends and neighbors that had banded together to build one house at a time, she would see a dizzyingly complex system of mortgage origination and securitization in which mortgages are pooled, sliced, and diced then sold by securities firms domestically and around the world. She would also see the most serious credit crisis of the last 25 years, fueled by defaulting subprime mortgages.

This crisis was brought about by massive securitization of subprime loans that were not credit-worthy. Mortgage loan originators quickly sold them into the securitized secondary market. If the borrower defaulted, the originator suffered no loss. Thus liberated from the moderating influence of credit risk, mortgage originators drastically relaxed their lending standards, issuing subprime “liar loans” requiring no documentation, interest only mortgages, no down payment mortgages, adjustable rate mortgages, and mortgages to people with impaired credit. Predatory lending also took place.

After the credit market imploded, threatening the U.S. and global economies, the federal government intervened. On July 31, 2008, the Housing and Economic Recovery Act (HERA) became law. It created a new regulatory agency, the Federal Housing Finance Agency (FHFA) to regulate government sponsored enterprises (GSEs) like Fannie Mae, and it authorized spending hundreds of billions of dollars to make sure that the GSEs would not fail.

However, HERA and its new agency, FHFA, only deal with the after-effects of poor lending practices. They support the banks, investment firms, asset management firms, and enterprises holding or guaranteeing securities backed by defaulting subprime mortgages. But they do not deal with the source of the problem, which lies in the origination of those defective mortgages.

This paper proposes reform of the credit market directed at the loan origination process, using a Sarbanes-Oxley (SOX) approach. While SOX is not perfect, and has not completely eliminated the misconduct that contributed to the financial meltdown of 2000-2001, it has deterred abuse[68]. SOX dealt with problems similar to those that caused our current credit crisis: lack of due diligence, conflict of interest, and breach of fiduciary duties. Using a SOX approach, a new federal regulatory agency would be created, patterned after the Public Company Accounting Oversight Board (PCAOB) created by SOX. This new agency would promulgate sound mortgage lending practices and standards, and then it would enforce them with periodic inspections and investigations.

A SOX approach to credit regulation would also include increasing the independence of firms like Standard and Poor’s, that provide ratings for mortgage-backed securities. It would require strong internal controls for firms that originate or securitize mortgages. It would also require the CFOs and CEOs of those firms to sign and confirm the reliability of their firms’ financial reports.

Many observers feel that more regulation of the credit market is on the way[69]. Our experience with SOX over the last six years can act as a useful guide in dealing with the current credit crisis.

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