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I. INTRODUCTION

The U.S. financial crisis of 2008 was primarily caused by the issuance of subprime mortgages.[1] Lenders were able to issue these loans, with little to no income or asset verification, because banking regulations were lax when it came to mortgage transactions.[2] This created a "housing bubble," which consisted of residential property that was valued lower than what borrowers owed on the mortgage.[3] As a result, many borrowers were "underwater" on their loans and had no choice but to foreclose on their properties because they could no longer make the minimum payments.[4] This result beckons the question: can more emphasis on the borrower's ability to repay his or her mortgage prevent another financial crisis?

Dodd-Frank was a response to the lack of banking oversight and has attempted to answer this question by creating regulations that would prevent lenders from issuing subprime loans, among other things.[5] The Federal Reserve subsequently passed regulations to address the requirements of Dodd-Frank.[6] To do this, the Federal Reserve substantially adopted the rules promulgated by the Basel Committee, which are known as the Third Basel Accord or Basel III.[7] Basel III does not have the force of law, but is rather an important global framework intended to promote financial growth and resilience in the banking sector.[8] With over 65% of Americans owning a home with a mortgage attached to it[9], any regulations based

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† J.D. Candidate, 2015, Hofstra University School of Law.[1] *See* S. SUBCOMM. ON INVESTIGATIONS, 112TH CONG., WALL STREET AND THE FINANCIAL CRISIS: ANATOMY OF A FINANCIAL COLLAPSE 24-25 (Apr. 13, 2011), *available at* http://www.hsgac.senate.gov/subcommittees/investigations/reports [hereinafter *Anatomy of a Financial Collapse*].

[1] *See* S. SUBCOMM. ON INVESTIGATIONS, 112TH CONG., WALL STREET AND THE FINANCIAL CRISIS: ANATOMY OF A FINANCIAL COLLAPSE 24-25 (Apr. 13, 2011), *available at* http://www.hsgac.senate.gov/subcommittees/investigations/reports [hereinafter *Anatomy of a Financial Collapse*].

[2] *Id.* at 19.

[3] *See id.* at 22.

[4] *See id.*

[5] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111 -203, 124 Stat. 1376 (2010)

[6] *See* Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule, 78 Fed. Reg. 62018-01 (Oct. 11, 2013).

[7] *See* Basel Comm. on Banking Supervision, Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems, 1 (2010), *available at* http://bis.org/publ/bcbs189.pdf.

[8] *See About the Basel Committee,* BASEL COMMITTEE ON BANKING SUPERVISION, http://www.bis.org/about (last visited Sept. 27, 2013).

[9] *See Households and Families: 2010*, U.S. CENSUS BUREAU (April 2012), *available at* http://www.census.gov/prod/cen2010/briefs/c2010br-14.pdf.

on Basel III that the Federal Reserve has implemented, must be scrutinized for mortgage reforms that focus on assessing the borrowers risk through the duration of his or her loan.

The Federal Reserve's implementation of Basel III does not address the purpose of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank" or "The Act"), which is to promote financial stability and consumer protection. Basel III does not take into account public policy encouraging consumer lending. Therefore, for banking regulations to be effective in promoting financial stability and consumer protection, it is necessary to modify lending practices to focus more on the borrower's ability to pay through the lifetime of a loan. By focusing on the borrower's ability to repay the loan, it is possible to resolve many of the issues that led up to the financial collapse. For example, lenders now have to ensure a borrower will not assume payments that he or she cannot afford, or use a property as collateral that cannot cover the full the amount of the loan.[10] Basic factors such as these can go a long way in preventing another financial crisis. Because the financial crisis was fueled by inadequate collateral used to secure mortgages as well as by lending practices through which borrowers with insufficient funds were able to obtain loans, it becomes necessary to review a borrowers risk not only when he or she applies for a loan, but through the lifetime of the loan. In the wake of the financial collapse of 2008, the United States has sought to create clearer guidelines for consumers and financial institutions to prevent future financial instability.[11] In passing Dodd-Frank, Congress aimed legislation at preventing issues such as subprime lending and deceptive lending practices.[12] The goal of the Act was to promote financial stability and consumer protection.[13] In response to the Act, the Federal Reserve implemented a series of capital conservation requirements for the banking industry to follow.[14] These requirements, are designed to keep banks capitalized in times of economic down-turn and are substantially based on Basel III.[15] Basel III attempts to achieve this result by setting minimum capital conservation requirements for banks to cover their losses.[16]

However, these federal banking regulations fail to address the lack of banking oversight with regards to lending. Banks continue to have the ability to sell mortgages originated through the course of business to Government Sponsored Entities, essentially creating a "revolving door" or liquidity for banks, while continuously increasing the burden on Government Sponsored Entities, such as Freddie Mac, to purchase loans and carry the risk.[17] Although the risk may have decreased since 2008 due to stricter guidelines for loan

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[10] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111 -203, 124 Stat. 1376,768 (2010)

[11] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111 -203, 124 Stat. 1376 (2010)

[12] *See id.*

[13] *Id.*

[14] *See* Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule, 78 Fed. Reg. 62018-01 (Oct. 11, 2013).

[15] *See* Basel Comm. on Banking Supervision, Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems, 1 (2010), *available at* http://bis.org/publ/bcbs189.pdf.

[16] *See id.*

[17] *See About Freddie Mac*, FREDDIE MAC, http://www.freddiemac.com/corporate/company_profile/our_business/ (last visited Jan. 24, 2014) [hereinafter *About Freddie Mac*].

originators, the economy as a whole, including the job market, is what influences the performance of loans.[18] Basel III fails to address these concerns because banking institutions will inevitably sell off their loans to fund new loans, allowing them to meet their capital conservation requirements.

A potential solution to this problem is bridging the gap between Dodd-Frank and banking regulations through lending reform, which remains a nationally encouraged activity. By accepting that banks need to have the ability to lend money while meeting capital conservation requirements, it is possible to put more emphasis on the lending and risk-assessment process to ensure the origination of quality loans. To do this, it is necessary to examine the current state of banking regulations in the form of Basel III, the cause of the 2008 financial crisis, the method by which Dodd-Frank seeks to promote financial stability and consumer protection, and the lending process and how it is affected by the new regulations.

II. THE FINANCIAL CRISIS OF 2008

The enactment of Basel III, Dodd-Frank, and the subsequent regulations passed by the Federal Reserve were done in response to the financial crisis of 2008. These regulations seek to address the underlying causes of the recession in order to ensure financial stability and consumer protection. For example, one of the leading causes of the financial crisis of 2008 was the mortgage market.[19] Under traditional lending practices, banks lent money to a homebuyer at a fixed-rate for thirty years.[20] The bank kept the mortgage and serviced it until it was paid off.[21] However, regulations limited the number of loans a bank could issue because the banks were required to keep a certain amount of capital in reserve.[22] Banking institutions sold the loans to other financial institutions and used the profits to issue new loans to circumvent the regulations.[23] The profits came from origination fees and not long-term servicing of these mortgages.[24]

Banks began using a financial instrument known as securitization to make a greater profit on mortgage sales.[25]

Securitization is the process by which a financial institution "bundles" a large number of mortgages together into a pool.[26] The financial institutions calculate the amount of mortgage payments that the pool of borrowers will remit.[27] These securitized mortgages are

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[18] *See* S. SUBCOMM. ON INVESTIGATIONS, 112TH CONG., WALL STREET AND THE FINANCIAL CRISIS: ANATOMY OF A FINANCIAL COLLAPSE 24-25 (Apr. 13, 2011), *available at* http://www.hsgac.senate.gov/subcommittees/investigations/reports [hereinafter *Anatomy of a Financial Collapse*].
[19] *See id.* at 17.
[20] *Id.*
[21] *Id.*
[22] *See id.*
[23] *See id.*
[24] *Id.*
[25] *Id.* at 18
[26] *Id.*
[27] *Id.*

then held by a corporation or a trust created by the financial institution.[28] These new bonds, known as Residential Mortgage Backed Securities (RMBS), are then sold to investors through a public offering.[29] The investor earns money by holding these bonds and collecting on the coupon rate, which is generated through the repayment of principal and interest.[30] RMBSs were originally based off of thirty year fixed-rate mortgages, which were relatively safe and yielded consistent returns to investors.[31] Lenders earned profits by originating these mortgages.[32] Investment banks earned profits by bundling these mortgages into RMBSs and subsequently selling them.[33]

As a result, the demand for residential mortgage-backed securities increased.[34] To meet the demand, banks began to lend to high-risk borrowers, which later became known as subprime borrowers.[35] Aside from disregarding the high-risk nature of unqualified borrowers, many banks issued loans with little to no verification of the borrower's income or assets.[36] Additionally, the banks required little or no down payment and used mortgage instruments that did not require a borrower to pay down the principal, which is known as a negative amortization loan.[37] At a certain point, the rate associated with subprime mortgages substantially increased, causing severe financial hardship for the borrower.[38] Banks also disregarded any potential fraud or inaccurate income information provided by borrowers.[39] To sustain the profits financial intuitions were earning and to ensure continued lending, banks began to issue new mortgage instruments specifically created to increase profits, without factoring in risk.[40]

These riskier products were sold to uninformed consumers and, as a result, began to destabilize the economy. One of the most common instruments used to entice borrowers into a mortgage was a Hybrid Adjustable Rate Mortgage (ARM).[41] An ARM would allow a borrower to pay a low, fixed rate ("teaser rate") for a specified period of time, typically ranging from two to five years.[42] Once this teaser rate expired, the rates would substantially

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28 *Id.*

29 *Id.*

30 *Id.*

31 *Id.*

32 *See id.*

33 *See id.*

34 *See id.*

35 *See id.*

> [N]oting that Federal Banking Regulators defined subprime borrows as those with one of the following characteristics: "(1) two or more 30-day delinquencies in the last 12 months or one or more 60-day delinquencies in the past 24 months; (2) a judgment or foreclosure in the past 24 months; (3) a bankruptcy in the last 5 years; (4) A relatively high default probability as evidenced by a credit score below 660; or a debt service to income ratio of 50% or more.

36 *Id.* at 19.

37 *See id.*

38 *See id.* at 20.

39 *See id.*

40 *See id.*

41 *Id.* at 21.

42 *Id.*

increase.[43] This left borrowers unprepared to pay much higher interest and principal payments.[44] Additionally, many of the original payments were known as "interest only," not requiring borrowers to pay any principal.[45] Once the introductory rates expired, borrowers attempted to refinance their mortgages to avoid the higher payments. [46] At some point, they were no longer able to refinance because they had not paid down any of the principal. This led to the value of their home being less than the amount they owed, which resulted in default and foreclosure.[47]

Another common tool used by banks was the Home Equity Loan.[48] Borrowers were often enticed by home equity loans because of the additional capital they would receive as cash.[49] This type of loan created liens against the borrower's home for the additional amount of equity the borrower took as a loan.[50] Aside from issuing these loans when the borrower had little to no equity in their home, many banks originated mortgages which included Home Equity Loans, which were used as the down payment for the home.[51] The resulting loan to value (LTV) percentage would often be as high as 100%. If the borrower defaulted, the lien holder would not recover anywhere near the full amount of the debt owed.[52]

Some borrowers took advantage of the Alt-A loan, or the more extreme version known as the stated income loan.[53] These loans essentially allowed banks to issue loans with limited or no documentation of a borrower's income or assets.[54] Alt-A loans also allowed a borrower to finance 100% of the mortgage through a loan.[55] Banks would not substantiate any of the stated income or assets, which borrowers typically inflated to ensure they would qualify for a loan.[56] With borrowers unaware of the consequences, and banks relying on the resilience of the real estate market, the economy continued to lose traction.

The final outcome was a push towards speed and volume by banking institutions to issue these subprime loans so that they may be securitized for investment purposes.[57] Banks would make their profits, sell the loans to investment banks, which would earn money through securitization, and they would then issue them to the public.[58] These subprime lending practices led to defaults, foreclosures, and financial ruin.[59] As a result, investors in RMBSs were no longer making money, and the entire financial structure began to unravel.[60]

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[43] *See id.*
[44] *See id.*
[45] *See id.* at 22.
[46] *See id.*
[47] *See id.* at 22.
[48] *Id.* at 23.
[49] *See id.*
[50] *See id.*
[51] *See id.*
[52] *See id.*
[53] *Id.* at 24.
[54] *See id.*
[55] *See id.*
[56] *See id.* at 24-25.
[57] *See id.*
[58] *See id.*
[59] *See id.*
[60] *See id.*

Because the consumer was a necessary party to this outcome, it became necessary not only to consider financial stability, but also consumer protection.

III. BASEL III

The Basel Committee functions to set prudential regulation of banks and provides a forum for cooperation on bank supervisory matters.[61] The Committee is located in Basel, Switzerland, which is also where the committee's Secretariat has his home office, based in the Bank for International Settlement...[62] The goal of the Basel Committee is to promote global financial stability by establishing minimum standards for prudential regulations on supervision of banks.[63] The standards are primarily directed at banks with an international presence.[64] The Committee focuses primarily on three aspects of effective banking supervision: guidelines, sound practice, and implementation.[65] Although there is no legal force behind the standards the committee sets forth, it encourages the importance of a convergence towards common standards.[66] As such, membership in the Basel Committee is voluntary and a number of countries have opted in to become members.[67]

The Third Basel Accord or Basel III is the culmination of the Basel Committee's most recent effort to set prudential regulation of banks.[68] The purpose of Basel III is to "strengthen the regulation, supervision and risk management of the banking sector."[69] Basel III builds on the prior accord, Basel II, by trying to improve the banking sectors' ability to absorb shocks from various financial and economic stresses, improve risk management and banking oversight, and strengthen transparency and disclosure in the banking sector.[70]

To accomplish these goals, Basel III focuses primarily on strengthening the global capital framework.[71] By first defining capital and then setting up a framework for risk coverage, including a capital conservation buffer, countercyclical buffer, and leverage ratio, Basel III seeks to address the need for financial stability and consumer protection.[72]

Basel III focuses on defining capital.[73] Through a uniform definition, Basel III seeks to prevent another crisis caused by an insufficient level of high quality capital.[74] Basel III

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[61] *See About the Basel Committee,* BASEL COMMITTEE ON BANKING SUPERVISION, http://www.bis.org/about (last visited Sept. 27, 2013).

[62] *Id.*

[63] *Id.*

[64] *See Basel Committee Membership*, BASEL COMMITTEE ON BANKING SUPERVISION, http://bis.org/bcbs/membership (last visited Sept. 27, 2013).

[65] *The Basel Committee's Work*, BASEL COMMITTEE ON BANKING SUPERVISION, http://bis.org/bcbs/bcbs_work.htm (last visited Sept. 27, 2013).

[66] *See About the Basel Committee*, *supra* note 51.

[67] *Basel Committee Membership*, *supra* note 54 (member countries include Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States).

[68] *See* Basel III, *supra* note 5.

[69] *See* Basel III, *supra* note 5, at 1.

[70] *Id.*

[71] *See id.* at 2.

[72] *See id.* at 2-11.

[73] *See id.* at 12.

defines the elements of Capital as Tier 1 and Tier 2 Capital.[75] In each of these Tiers, the capital must be a certain percentage of risk-weighted assets.[76] Risk-weighted assets are defined as a bank's assets weighted according to the risk they carry.[77] These risk-weighted assets are the ratio of capital a bank must hold relative to the amount of money it lends out.[78] Tier 1 capital consists of common equity Tier 1 and Additional Tier 1.[79] Common Equity Tier 1 must be at least 4.5% of risk-weighted assets at all times.[80] Tier 1 Capital must be at least 6.0% of risk-weighted assets at all times.[81] Total Capital (Tier 1 and Tier 2) must be at least 8.0% of risk-weighted assets at all times.[82] Common Equity Tier 1 capital is the most resilient type of capital.[83]

Additionally, Basel III emphasizes that common shares are the primary instrument to absorb losses.[84] The next most effective instrument for absorption of losses is Additional

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[74] *See id.*

[75] *Id.*

[76] *See id.*

[77] *Risk Weighted Assets,* INVESTOPEDIA.COM., http://www.investopedia.com/terms/r/riskweightedassets.asp (last visited Oct. 15, 2013).

[78] *See id.*

[79] *See* Basel III, *supra* note 5, at 12.

[80] *Id.*

[81] *Id.*

[82] *Id.*

[83] *Id.* at 13.

> Common Equity Tier 1 capital consists of the sum of the following elements: Common shares issued by the bank that meet the criteria for classification as common shares for regulatory purposes, stock surplus resulting from the issue of instruments included in common equity Tier 1, retained earnings, accumulated other comprehensive income and disclosed reserves, common shares issued by consolidated subsidiaries of the bank and held by third parties that meet the criteria for inclusion in common equity Tier 1 capital, and regulatory adjustments applied in the calculation of common equity Tier 1.

[84] *Id.* at 14.

> Criteria for classification as common shares for regulatory capital purposes: capital must represent the most subordinate claim in liquidation of the bank, entitled to a claim on residual assets that is proportional with its share of issue capital after all senior claims have been repaid in liquidation, principal is perpetual and never repaid outside of liquidation, the bank does nothing to create the expectation at issuance that the instrument will be bought back, redeemed, or cancelled nor do the statutory or contractual terms provided any feature which might give rise to such expectation, distributions are paid out of distributable items, there are no circumstances under which the distributions are obligatory, distributions are paid only after all legal and contractual obligations have been met and payments on more senior capital instruments have been made, it is issued capital that takes the first and proportionately greatest share of any losses as they occur, the paid in amount is recognized as equity capital for determining balance sheet insolvency, the paid in amount is classified as equity under relevant accounting standards and it is directly issued and paid in and the bank cannot directly or indirectly have funded the purchase of the instrument, the paid in amount is neither secured nor covered by a guarantee of the issuer or related entity or subject to any other arrangement that legally or economically enhances the seniority of the claim, it is only issued with the approval of the owners of the issuing bank, and it is clearly and separately disclosed on the banks' balance sheet.

Tier 1 Capital.[85] The criterion for inclusion in Additional Tier 1 Capital is very similar to Common Equity Tier 1 Capital.[86] The final and less resilient type of capital is Tier 2 Capital.[87] The criterion for inclusion in Tier 2 Capital is more relaxed than the requirements for capital that has greater loss absorbing potential.[88]

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[85] *Id.* at 15.

> Additional Tier 1 Capital consists of the sum of the following elements: instruments issued by the bank that meet the criteria for inclusion in Additional Tier 1 capital and are not included in common equity Tier 1, stock surplus resulting from the issue of instruments included in additional Tier 1 capital, instruments issued by consolidated subsidiaries of the bank and held by 3rd parties that meet the criteria for inclusion in additional Tier 1 capital and are not included in common equity Tier 1, and regulatory adjustments applied in the calculation of additional Tier 1 capital.

[86] *Id.* at 15-17.

> Criteria for Inclusion in Additional Tier 1 Capital: issued and paid in, subordinated to depositors, general creditors and subordinated debt of the bank, is neither secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim, is perpetual, may be callable at the initiative of the issuer only after a minimum of five years, any repayment of principal must be with prior supervisory approval, dividend and coupon discretion, dividends and coupons must be paid out of distributable items, the instrument cannot have a credit sensitive dividend feature, the instrument cannot contribute to liabilities exceeding assets if such a balance sheet test forms part of national insolvency law, instruments classified as liabilities for accounting purposes must have principal loss absorption through either conversion to common shares at an objective pre-specified trigger point or a write down mechanism which allocates losses to the instrument at a pre specified trigger point, neither the bank nor a related party over which the bank exercises control or significant influence can have purchased the instrument, nor can the bank directly or indirectly have funded the purchase of the instrument, the instrument cannot have any features that hinder recapitalization, if the instrument is not issued out of an operating entity or the holding company in the consolidated group proceeds must be immediately available without limitation to an operating entity.

[87] *Id.* at 17.

> Tier 2 Capital consists of the sum of the following elements: Instruments issued by the bank that meet the criteria for inclusion in Tier 2 capital and are not included in Tier 1 capital, stock surplus resulting from the issue of instruments included in Tier 2 capital, instruments issued by consolidated subsidiaries of the bank and held by third parties that meet the criteria for inclusion in Tier 2 capital and are not included in Tier 1 capital, certain loan loss provisions and regulatory adjustments applied in the calculation of Tier 2 capital.

[88] *Id.* at 18-19.

> Criteria for inclusion in Tier 2 Capital: instruments must be issued and paid in, subordinated to depositors and general creditors of the bank, neither secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim, maturity, may be callable at the initiative of the issuer only after a minimum of five years, the investor must have no rights to accelerate the repayment of future scheduled payments except in bankruptcy or liquidation, the instrument cannot have a credit sensitive dividend feature, neither the bank nor a related party over which the bank exercises control or significant influence can have purchased the instrument, if the instrument is not issued out of an operating entity of the holding company in the consolidated group proceeds must be immediately available without limitation to an operating entity.

Basel III also sets forth additional capital requirements such as the capital conservation buffer.[89] The purpose of this buffer is to ensure that banks build up capital buffers outside periods of stress that can be drawn down as losses are incurred.[90] When buffers have been drawn down, banks are encouraged to reduce discretionary distributions of earnings, such as bonus payments.[91] The 2.5% capital conservation buffer, which comprises Common Equity Tier 1, has been established above the regulatory minimum capital requirements.[92]

Another regulatory instrument proposed by Basel III is the countercyclical buffer.[93] Basel III takes notice that losses incurred in the banking sector can be extremely large when a downturn is preceded by a period of excess credit growth.[94] The purpose of the countercyclical buffer is aimed to ensure that capital requirements take account of the macro-financial environment in which banks operate.[95] This buffer consists of 0-2.5% of risk-weighted assets, depending on the regulatory institutions' judgment as to the extent of buildup of system wide risk.[96]

IV. FAILURE OF BASEL II

The need for more specific banking regulations to promote financial stability arose out of the failure of Basel II. The goal of Basel II was to "produce risk-based capital requirements that are more risk-sensitive than those produced under the agencies' existing risk-based capital rules."[97] To facilitate this goal, the Federal Reserve adopted an "advanced internal ratings-based approach (IRB).[98] The IRB approach used the banks' internal system to calculate the banks' credit risk capital requirements.[99] This approach required banks to establish risk-based capital requirements, and to maintain a minimum risk-based capital ratio requirement.[100] These ratios consist of the different types of capital, collectively known as total qualifying capital, which consist of Tier 1 and Tier 2 capital.[101] These assets are then weighed against the risk a bank carries to determine whether minimum risk-based capital ratio requirements have been met. [102] Total qualifying capital was the sum of Tier 1 and Tier 2

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[89] *Id.* at 54.
[90] *Id.* at 55.
[91] *See id.*
[92] *Id.* at 56.
[93] *See id.* at 57.
[94] *Id.* at 57-59.
[95] *See id.*
[96] *Id.* at 58.
[97] Risk-Based Capital Standards: Advanced Capital Adequacy Framework – Basel II, 72 Fed. Reg. 69288-01 (Dec. 7, 2007).
[98] *Id.*
[99] *See id.*
[100] *See id.*
[101] *Id.* "The risk-based capital ratio requirements consist of 4% Tier 1 capital to total risk weighted assets and a minimum of 8% total qualifying capital to risk weighted assets."
[102] *See id.*

capital elements. [103] By using their internal ratings-based approach, banks would establish the risk weight of securitized assets through external rating agencies. [104]

However, the failure of Basel II was caused by more than its capital ratio requirements alone. Basel II lacked a capital conservation buffer as well as a countercyclical buffer. [105] The purpose of the capital conservation buffer is to ensure that banks are consistently preparing for economic downturn by building up capital buffers in times of economic growth.[106] The countercyclical buffer is designed to increase the amount of capital required during times of economic expansion and decrease when there is economic contraction.[107] The goal of the countercyclical buffer is to allow a bank to operate efficiently by anticipating changes in the economic cycle.[108] The lack of these buffers under Basel II created undercapitalized banks, which were not prepared for the economic contraction created by the home lending market. As a result, banks were unable to offset their losses and were forced to take on more debt than available capital.[109] This directly led to the U.S. financial crisis of 2008, something Basel III seeks to prevent through the addition of these buffers.[110]

V. RESPONSE TO THE FINANCIAL CRISIS –DODD-FRANK

The purpose of Dodd-Frank is to prevent another financial crisis by focusing on the "accountability and transparency" of the financial system so that consumers will not be subject to abusive or deceptive financial practices.[111] One way the Act sets out to accomplish this purpose is through improving the regulation of bank and savings association holding companies and depositary institutions.[112] The power to regulate banks has been explicitly granted to the Board of Governors of the Federal Reserve System.[113]

Provisions in Dodd-Frank regarding banking regulation are limited, primarily focusing on defining financial institutions and describing lending limits associated with such institutions.[114] To the extent banking regulation is discussed in the Act, capital regulations are required to be countercyclical, which requires banks to increase their capital reserves when the economy is doing well, while allowing banks to decrease these reserves when the economy is contracting.[115] Therefore, to correctly analyze whether the Federal Reserve's Implementation of Basel III properly addresses the requirements set forth in Dodd-Frank, it is prudent to examine provisions related to the underlying cause of the 2008 Financial Crisis – mortgage lending.[116]

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[103] *Id.*
[104] *Id.*
[105] *See id.*
[106] *See* Basel III, *supra* note 5, at 54.
[107] Dodd-Frank, *supra* note 1, at 240.
[108] *See* Regulatory Capital Rules, *supra* note 4, at 15.
[109] *See* ANATOMY OF A FINANCIAL COLLAPSE, *supra* note 8, at 24-25.
[110] *See* Basel III, *supra* note 5.
[111] *See* Dodd-Frank, *supra* note 1.
[112] Dodd-Frank, *supra* note 1, at 221,
[113] 12 U.S.C. § 3902 (2012).
[114] *See* Dodd-Frank, *supra* note 1 at, 102.
[115] Dodd-Frank, *supra* note 1, at 240.
[116] *See id.* at 761.

The Mortgage Reform and Anti-Predatory Lending Act seeks to reform the lending process to promote the financial stability of the United States by defining mortgage originators and setting forth requirements for every mortgage transaction.[117] For example, one primary source of profits for a bank is consumer home lending.[118] By lending out money, a bank is constantly changing its risk-weighted capital.[119] As a consequence of this, an examination of the reforms to mortgage practices is essential to determine whether the Federal Reserve's implementation of Basel III is in-line with the requirements of Dodd-Frank, and whether the capital requirements are proper in light of the mortgage reform.

Mortgage Reform and Anti-Predatory Lending Act

The purpose of the Mortgage Reform and Anti-Predatory Lending Act is to protect borrowers from unreasonable or complicated mortgage terms that do not properly reflect the borrower's ability to repay the loan.[120] The Mortgage Reform and Anti-Predatory Lending Act seeks to accomplish this by regulating the issuance of credit while ensuring that credit is available for qualified consumers.[121] The fundamental requirement prescribed by the Act through residential loan origination standards is that all loan originators are qualified, licensed, and registered.[122] By keeping track of those who assist a consumer in obtaining a residential mortgage loan, this Act attempts to prevent predatory lending by people and institutions that hold themselves out to be "creditors" but lack the necessary supervision to protect consumers and the economy from subprime lending practices.[123]

Additionally, this Act prohibits loan originators from receiving any fees as compensation that are based on the terms of the loan.[124] By doing so, this Act essentially discourages lenders from using deceptive and unfair practices to direct borrowers into buying products that may not be financially responsible, simply because there is a greater fee available to the originator for that specific product. As an added security measure, the Act imposes damages on the mortgage originators for violating these rules.[125] The potential damages include the greater of actual damages or an amount equal to three times the total amount of compensation received by the originator, plus reasonable attorney's fees.[126]

The Mortgage Reform and Anti-Predatory Lending Act requires that every creditor make a "reasonable and good faith" determination based on verified and documented information that the consumer has a reasonable ability to repay the loan, including the principal, interest, taxes, and insurance.[127] This requires a creditor to examine the borrower's credit history, current income, reasonably expected income, current obligations, debt to

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117 *Id.*

118 *See* ANATOMY OF A FINANCIAL COLLAPSE, *supra* note 8, at 17.

119 *See id.*

120 Dodd-Frank, *supra* note 1, at 764.

121 *Id.*

122 *Id.*

123 *See id.*

124 *Id.*

125 *Id.* at 766.

126 *Id.*

127 *Id.* at 767.

income ratio, employment status, and other real property held by the borrower.[128] The creditor is required to look at not only the loan being originated, but also any additional loans the borrowers may have to determine his or her ability to repay the loan.[129] By requiring creditors to follow these guidelines, the Act seeks to prevent lending to borrowers that cannot repay their obligations.

Income verification is the backbone of this process.[130] To verify income, lenders are required to review a borrower's W-2s, tax returns, payroll receipts, financial institution records, and other third-party documents that are being relied upon to determine credit-worthiness.[131] This verification process protects the lender and the consumer by providing a reliable indication of the consumer's ability to repay the particular product he selected, taking into account all other obligations the consumer may have. This establishes the borrower's debt-to-income ratio (DTI). Most banks now requires that borrowers have a DTI that is equal to or less than 36%, while the Government Sponsored Entities require a DTI equal to or less than 45% for qualified mortgages.[132]

One of the major factors that contributed to the financial crisis of 2008 was a lack of properly appraised properties.[133] The Act combats the use of subprime lending by regulating appraisal activities.[134] The purpose of an appraisal is to verify that the loan amount is appropriate to the value of the property. Part of the reason that RMBSs lost their value was due to incorrect evaluation of home values, leading to mortgages that were in excess of the property's value.[135] Therefore, when a borrower foreclosed on his property, a lender could not recover the full amount of the mortgage by selling the property, resulting in large losses. The Act now requires an appraisal to be conducted on every "higher-risk mortgage."[136] This definition essentially includes every residential mortgage that is originated by the lender.[137]

Appraiser independence and unbiased judgment are important factors used to ensure the validity of a property's value.[138] Appraiser independence, which is regulated by the Uniform Standards of Professional Appraisal Practice (USPAP), requires that appraisers comply with independence requirements, making sure there is no conflict of interest or anything that would influence the appraiser to incorrectly value a property. [139] The value that

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128 *Id.* at 768.

129 *See id.* at 767.

130 *See id.* at 768.

131 *Id.*

132 *See generally Underwriting Training and Education Resources*, FREDDIE MAC (Sept. 2013), *available at* http://www.freddiemac.com/learn/pdfs/uw/underwriting_resources.pdf [hereinafter *Underwriting Resources*].

133 *See* ANATOMY OF A FINANCIAL COLLAPSE, *supra* note 8, at 15.

134 Dodd-Frank, *supra* note 1, at 810.

135 *See generally Underwriting Resources*, *supra* note 122.

136 Dodd-Frank, *supra* note 1, at 810.

137 Dodd-Frank, *supra* note 1, at 812.

[D]efining a higher-risk mortgage as:

> one with an annual percentage rate (APR) that exceeds the average prime rate by 1.5% in the case of first lien mortgage that does not exceed the maximum principle loan amount; 2.5% in the case of a first lien mortgage that does exceed the maximum principle loan amount; and by 3.5% for subordinate lien mortgages.

138 *See id.*

139 *Id.* at 813.

the appraiser determines is then used in the underwriting process to screen for red flags, such as property flipping and misrepresentation by the current owners of the property.[140] The appraisal is also an effective tool for lenders to determine the risk associated with recouping an outstanding mortgage as a result of foreclosure.[141]

Although these are all potential solutions to prevent subprime lending, the greater problem remains – the banks' ability to sell off all qualified loans to Government Sponsored Enterprises (GSEs).[142] The Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) were chartered by Congress to "ensure a reliable and affordable supply of mortgage funding."[143] These GSEs work as a secondary market for mortgages, where a lender can sell mortgages it originated, allowing for "revolving liquidity" to originate more mortgages.[144] By 2004, the GSEs had purchased $175,000,000,000 in subprime mortgages.[145] From 2004 to 2007, this number increased to $1,000,000,000,000.[146] This was debt that lenders were no longer responsible for, but were contributing to on a systematic basis.

The GSEs currently own or guarantee 75% of all newly originated mortgages and own 13.3% of outstanding debt in the United States.[147] Additionally, they have issued RMBSs for 31% of the residential debt market, a combined total of 44.3% of the outstanding mortgage debt in the United States.[148] As a result of the financial crisis, the Treasury Department has agreed to purchase 79.9% of each GSEs common stock, potentially exposing taxpayers to upwards of $5,300,000,000,000 worth of risk.[149] The function of the GSEs and their continued purchase of loans originated by banks across the country is the issue that should be addressed by Dodd-Frank and Basel III. To meet the goals of financial stability and consumer protection, lending practices must be reevaluated, and a new framework, with more accountability, should be developed.

VI. FEDERAL RESERVE IMPLEMENTATION OF BASEL III

The Federal Reserve has substantially implemented Basel III as U.S. Domestic Law.[150] The primary reason for implementing these rules was the insufficiency of high-quality capital held by banking organizations to absorb the losses generated by the financial crisis in 2008.[151] The Federal Reserve seeks to clearly define the characteristics of regulatory capital instruments.[152] Consistent with Basel III, the Federal Reserve has determined the final

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140 *See Underwriting Resources*, *supra* note 122.

141 *See id.*

142 Dodd-Frank, *supra* note 1, at 830.

143 *Id.*

144 *See Government Sponsored Enterprises,* FEDERAL HOUSING FINANCE AGENCY, http://www.fhfa.gov/Default.aspx?Page=33 (last visited Jan. 02, 2014).

145 Dodd-Frank, *supra* note 1, at 830.

146 *Id.*

147 *Id.*

148 *Id.*

149 *Id.* at 831.

150 *See generally* Regulatory Capital Rules, *supra* note 4.

151 *See* Regulatory Capital Rules, *supra* note 4, at 93.

152 *See id.*

minimum capital ratios of common equity Tier 1 capital to risk-weighted assets of 4.5%; a ratio of Tier 1 capital to risk-weighted assets of 6%; a ratio of total capital to risk-weighted assets of 8%; a ratio of Tier 1 capital to average total consolidated assets of 4%; and an additional requirement for banks that the ratio of Tier 1 capital to total leverage exposure be at least 3%.[153]

Additionally, the rule applies a capital conservation buffer equal to 2.5% of risk-weighted assets above the minimum risk-based capital ratio requirements, which could be expanded by a countercyclical buffer.[154] The countercyclical buffer would initially be set at 0% and could expand to as much as 2.5% of risk-weighted assets.[155] The rule also applies a 4% minimum leverage ratio requirement to all banking organizations and eliminates exceptions for banking organizations with strong supervisory ratings.[156] Furthermore, by defining regulatory capital components, the rule is designed to create specific guidelines to be used in calculating risk-based capital ratios. [157] However, these definitions for risk-weighted assets and guidelines for calculating capital ratios do not take into account lending practices.[158] As a result, these regulations do not address the goal of financial stability.

VII. THE ADOPTION OF BASEL III BY THE FEDERAL RESERVE DOES NOT PROPERLY ADDRESS THE NEED FOR FINANCIAL STABILITY AND CONSUMER PROTECTION AS SET FORTH IN DODD-FRANK.

There is a substantial need for people to have the ability to obtain mortgages.[159] For example, as of 2009, there were 76,428,000 total mortgages outstanding. [160] Further, in 2010, there were a total of 116,716, 292 households in the United States.[161] Looked at another way, over 65% of homeowners own their homes with a mortgage attached to it. For this reason, lending remains a primary concern for banks, government organizations and, more importantly, borrowers.[162] As a result of the financial crisis of 2008, almost every household was affected in some way.[163] The majority of affected mortgages were owned by major financial institutions, with an outstanding mortgage debt ownership of $4.8 billion by 2007;

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153 *Id.* at 85.

154 *Id.*

155 *Id.*

156 *Id.*

157 *See id.*

158 *See* BD. OF GOVERNORS OF THE FED. RESERVE. FED. DEPOSIT INS. CORP. & OFFICE OF THE COMPTROLLER OF CURRENCY NEW CAPITAL RULE: COMMUNITY BANK GUIDE (July 2013) P1, *available at* http://www.federalreserve.gov/bankinforeg/basel/files/capital_rule_community_bank_guide_20130709.pdf.

159 *See generally Mortgage Characteristics-Owner Occupied Units: 2009*, U.S. CENSUS BUREAU (2012), *available at* http://www.census.gov/compendia/statab/2012/tables/12s0998.pdf.

160 *Id.*

161 *See Households and Families: 2010*, U.S. CENSUS BUREAU (April 2012), *available at* http://www.census.gov/prod/cen2010/briefs/c2010br-14.pdf.

162 *See supra* note 149; *See also id.*

163 *See* U.S. FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES (Jan. 2011), *available at* http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf.

while the GSEs owned a significantly smaller portion, totaling $562 million.[164] Today, there are various programs encouraging homeowners to refinance their homes; offering assistance in the form of mortgage products that do not require a borrower to provide financial statements or proof of income. [165] Additionally, the Government is actively seeking to provide borrowers with essential information relating to refinancing, to encourage home lending.[166]

As a general policy matter, the Government has been proactive in the way it has addressed lending concerns.[167] After all, there is a total outstanding mortgage debt totaling over $13 billion.[168] Through the GSEs, concrete guidelines have been put in place for lenders to follow when evaluating a borrower's ability to pay. [169] The guidelines include the evaluation of collateral, credit, income and assets, and mortgage insurance in an effort to prevent subprime lending. [170] However, one of the major factors these guidelines fail to address is long-term performance in light of unemployment rates and job security concerns. [171] Although the unemployment rate has decreased dramatically since early 2009, it is still high, with some industries affected more than others.[172] Additionally, it is important to note that the unemployment rate does not reflect those people who are no longer actively looking for work.[173] For lending guidelines to be effective, factors such as the unemployment rate, job security, and industry growth should be included in the underwriting framework. [174] By placing a greater emphasis on the borrower, overall lending risk can be decreased. [175] However, one problem still remains; the ability for banks to circumvent capital conservation requirements by selling off loans they originate to the GSEs.[176]

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[164] *See June 2007 Statistical Supplement—Mortgage Debt Outstanding*, THE FEDERAL RESERVE BOARD, (July 2007), *available at* http://www.federalreserve.gov/pubs/supplement/2007/06/table1_54.htm [hereinafter *Mortgage Debt 2007*].

[165] *See generally Home Affordable Refinance Program (HARP),* MAKING HOME AFFORDABLE, http://www.makinghomeaffordable.gov/programs/lower-rates/Pages/harp.aspx (last visited Jan. 24, 2014).

[166] *See generally The Plan to Help Homeowners,* THE WHITE HOUSE, http://www.whitehouse.gov/refi (last visited Jan. 24, 2014).

[167] *See March 2013 Statistical Supplement—Mortgage Debt Outstanding*, THE FEDERAL RESERVE BOARD, (March 2013), *available at* http://www.federalreserve.gov/econresdata/releases/mortoutstand/current.htm [hereinafter *Mortgage Debt 2013*].

[168] *Id.*

[169] *See generally Underwriting Resources supra* note 122.

[170] *See id.*

[171] *See id.*

[172] *See Labor Force Statistics from the Current Population Survey,* BUREAU OF LABOR STATISTICS (Jan. 2014), *available at* http://data.bls.gov/timeseries/LNS14000000 (reflecting unemployment rates as high as 10% from 2009-2010, and dropping down to 6.7% by Dec. 2013).

[173] *See How the Government Measures Unemployment*, BUREAU OF LABOR STATISTICS (Feb. 2009), *available at* http://www.bls.gov/cps/cps_htgm.pdf.

[174] *See generally O*Net,* U.S. DEP'T OF LABOR, http://www.onetonline.org/ (last visited Jan. 24, 2014)

[175] *See Underwriting Resource supra* note 122.

[176] *See* Regulatory Capital Rules, *supra* note 4, at 17.

VIII. BASEL III CANNOT ADDRESS THE PROBLEM

A. Current State of banking regulation and the economy

The implementation of Basel III has constricted the banks' ability to lend money by setting standards for defining capital and attaching a risk-weighted ratio to different forms of capital with which the banks work.[177] Additionally, by removing Tier 3 capital and adding on an additional capital conservation buffer of 2.5%, as well as a countercyclical buffer with a range of 0% to 2.5%, the Federal Reserve seeks to prevent banks from being illiquid in times of financial downturn.[178] However, this enhanced risk coverage does not take into account lending, which is the greatest risk endeavor a bank can undertake.[179] After a bank originates a loan, it is sold in the secondary market. [180] The GSEs are the largest purchasers of home loans in the country. [181] GSEs will guarantee all mortgages up to a certain dollar amount; $417,000 for most of the nation and $625,000 in certain high cost areas.[182] The stated purpose of the GSEs is to ensure that "lenders have mortgage money to lend."[183]

As of the third quarter of 2013, there is over $13 billion of outstanding mortgage debt.[184] Banks and similar financial institutions currently own $4.3 billion, while the GSEs own close to $5 billion.[185] The majority of loans any bank will own, rather than sell off to a GSE, inevitably carry less risk.[186] The underwriting guidelines in place have been established by the GSEs and are designed to assist banks with the origination process to help reduce the risk associated with loans the GSEs purchase from the banks. [187] As a result, banks are free to set their own underwriting standards for loans that do not conform to the criteria established by the GSEs.[188] This leads to a result where banks can dramatically decrease lending risk by setting stricter underwriting guidelines.[189] While GSEs require a maximum debt to income ratio of 45% to approve a loan, certain banks list a maximum debt to income ratio of 36% on their websites.[190] For other types of loans, such as those that exceed the purchasing limits of the GSEs, banks can require even stricter standards. [191] This allows banks to actively manage their risk and choose how much debt to hold, circumventing capital conservation

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[177] *See id.* at 19.

[178] *See id.* at 85; *see also* Basel II, 72 Fed. Reg. 69288-01 (Dec. 7, 2007).

[179] *Supra* note 87

[180] *See id.*

[181] *See Mortgage Debt 2013, supra* note 157.

[182] *See About Freddie Mac, supra* note 7.

[183] *See id.*

[184] *See Mortgage Debt 2013, supra* note 157.

[185] *Id.*

[186] *See generally Underwriting Resources, supra* note 122.

[187] *See id.*

[188] *See id.*

[189] *See Applying for a Loan,* BANK OF AMERICA, https://www.bankofamerica.com/home-loans/mortgage/applying-for-a-loan/how-mortgages-are-approved.go (last visited Jan. 24, 2014) (listing a maximum DTI of 36%).

[190] *See National Underwriting Summary*, Mortgage Guarantee Insurance Company (Dec. 2, 2013), *available at* http://www.mgic.com/pdfs/71-42978_uw_summary_current.pdf.; *See also id.*

[191] *See generally Underwriting Resources, supra* note 122.

requirements.[192] Basel III does not take this framework into account and thereby, cannot adequately address the goals of financial stability and consumer protection which Dodd-Frank advances.

Current underwriting guidelines require an assessment of a number of factors when approving a loan that will be later bought by a GSE.[193] The first factor, collateral, requires an underwriter to review an appraisal of the property sought to be mortgaged, calculate a loan to value ratio, and determine whether it conforms to GSE underwriting requirements. [194] Then, through a review of a borrower's credit, including his income, assets, credit score and debts, an underwriter determines the debt to income ratio.[195] Taking these items together, the underwriter must view the borrower's risk in its totality to determine whether the borrower has an ability to pay.[196] However, in this verification process, factors such as a borrower's future earnings potential and job security are not considered.[197] As a result, the risk allocated for a conventional thirty-year mortgage does not extend to the entire life of the mortgage.[198] Instead, it only goes as far as to consider the last two years of employment. Assuming that the earning potential of the borrower will not change, this process can only reflect the ability of a borrower to repay for two years going forward.[199]

With over 1.2-million foreclosures at some stage of the process right now, it is possible that current lending guidelines are not the best measure for a borrowers' ability to repay a loan.[200] At a current ratio of around 1.5%, the foreclosure rate accounts for roughly $195 million of bad-debt that banks and GSEs have to account for.[201] Given that banks have the ability to insulate themselves from loans that carry larger amounts of risk; it is safe to assume that this loss has to be attributable to the GSEs.[202] This leads to the question of accountability. If the banks originated these mortgages using GSE guidelines, and later sold the loans to the GSEs, it is necessary to determine which entity is accountable for the resulting failure of a borrower to repay the loan.[203] However, the reality is that both entities carry their own share of the responsibility; a bank, by originating the mortgage, and GSEs, by purchasing the mortgages on the secondary market.[204] The potential solution to this problem is to reevaluate lending guidelines and create a system that is more representative of the borrower's ability to repay the loan. In turn this type of framework will promote financial stability and adequately protect consumers.

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[192] *See id.*

[193] *See id.*

[194] *See id.*

[195] *See id.*

[196] *See id.*

[197] *See id.*

[198] *See id.*

[199] *See id.* (taking into consideration that if a person's income is verified for the prior two years - that is only sufficient to conclude that the income will stay the same for the next two years).

[200] *See generally National Real Estate Trends & Market Info,* REALTYTRAC, http://www.realtytrac.com/statsandtrends (last visited Jan. 24, 2014).

[201] *See Mortgage Debt 2013, supra* note 157.

[202] *See id.*

[203] *See About Freddie Mac*, *supra* note 7.

[204] *See Underwriting Resources, supra* note 122.

B. Still a lack of accountability

The GSEs currently hold close to $5 billion of the mortgage debt in the country.[205] This has been a dramatic increase from the $560 million they held in 2007.[206] One of the primary reasons for this ten-fold increase was the multi-billion dollar bail-out of banking institutions.[207] As a result, the United States has leveraged its policy of promoting lending against the resiliency of the GSEs to carry the debt.[208] This "revolving door" system of allowing banks to originate loans and then sell them off to GSEs, defeats the purpose of Basel III as it has been adopted by the Federal Reserve.[209] It follows that the Federal Reserve does not adequately address the need for financial stability and consumer protection as set forth in Dodd-Frank.[210] Instead, this system allows for banks to categorically sell loans that carry higher risk to GSEs, in turn, freeing up capital for additional lending.[211]

While Basel III seeks to prevent banks from becoming illiquid by setting capital conservation requirements through defining and calculating risk-weighted asset ratios, the policy of the GSEs to "ensure that lenders have mortgage money to lend" undermines that goal.[212] This calls for a solution that promotes lending, while still taking into account long-term risk. There is no way to tighten the capital conservation requirements set by the Federal Reserve without decreasing a bank's lending ability.[213] Instead, by focusing more on the borrower, through regulations that accurately evaluate a borrowers financial abilities, a solution can be implemented that still allows banks to freely lend money; while ensuring that the resulting mortgages will have sustainable, long-term performance, without increasing debt to income or loan to value requirements.[214] As a result, the GSEs will be able to purchase loans that carry less risk which will lead to a lower probability of the borrower defaulting.

C. Need for more specific guidelines

The problem with current banking regulations and, in turn, lending practices, is the lack of long-term risk assessment. The current system fails to account for what happens during the lending process.[215] Instead, it leaves risk guidelines to the government by allowing GSEs to set the minimum standards required to approve a loan.[216] As a result, banks are not obligated to follow the highest standards for risk review.[217] Banks are only required to make a "good-faith effort" to ensure that the borrower has the ability to repay a loan.[218] The

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205 *See Mortgage Debt 2013*, *supra* note 157.

206 *See id; see also Mortgage Debt 2007, supra* note 154.

207 *See generally* THE FINANCIAL CRISIS INQUIRY REPORT, *supra* note 153.

208 *See About Freddie Mac, supra* note 7.

209 *See id.*

210 *See* Dodd-Frank, *supra* note 1.

211 *See About Freddie Mac, supra* note 7.

212 *See* Regulatory Capital Rules, *supra* note 4, at 19; s*ee also id.*

213 *See* Regulatory Capital Rules, *supra* note 4, at 78.

214 *See Underwriting Resources, supra* note 122.

215 *See* Dodd-Frank, *supra* note 1, at 764.

216 *See Underwriting Resources, supra* note 122.

217 *See id.*

218 *See* Dodd-Frank, *supra* note 1, at 763.

responsibility for a loan's performance subsequently falls onto the GSEs.[219] This occurs due to the use of automated systems such as Loan Prospector to underwrite mortgages.[220] This takes much of the underwriting process out of the hands of registered mortgage underwriters, and instead puts it in the hands of a computer system that analyzes the risk of the collateral, credit, and debt of a borrower.[221] Although the underwriter still has the responsibility to review the information provided, automation makes the approval process for mortgages less reliable.[222]

As a result of the subprime mortgage crisis, Congress passed Dodd-Frank.[223] The purpose of Dodd-Frank is to address the need for financial stability and consumer protection by setting requirements that all financial institutions must follow.[224] Many of the requirements deal with the treatment of consumers, requiring certain disclosures and standards that organizations must adhere to.[225] Additionally, the Act sets requirements related to mortgage lending, which focus on the borrower's ability to repay the loan and restricts the issuance of certain high-risk loans.[226] However, it allows the Federal Reserve to institute banking regulations in accordance with the Act.[227] In response to the financial crisis of 2008, the Federal Reserve adopted Basel III, which significantly tightened banking capital conservation requirements as compared to those previously set by Basel II.[228] By instituting a capital conservation buffer and a countercyclical buffer, the Federal Reserve aimed at preventing financial institutions from taking on more risk than they can cover.[229] However, this current structure creates a disconnect between mortgage lending and capital conservation requirements.

It has traditionally been the policy of the United States to promote home ownership.[230] This has been done by making mortgages available to borrowers seeking to purchase a home.[231] The creation of the GSEs allowed for banks to have a continuous ability to lend money by selling off loans they originated to the GSEs.[232] The problem with this scheme is that it does not hold anyone accountable for the failure of a borrower to pay his or her mortgage.[233] Instead, this scheme allows for the GSEs to set underwriting guidelines to evaluate risk, leaving the actual review in the hands of banking institutions through the use of automated systems.[234] Once the bank approves the loan, sells it to the GSEs, and gets back its

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219. *See About Freddie Mac*, *supra* note 7.
220. *See Loan Prospector,* FREDDIE MAC, http://www.loanprospector.com/welcome/ (last visited Jan. 24, 2014).
221. *See id.*
222. *See About Freddie Mac, supra* note 7.
223. *See* Dodd-Frank, *supra* note 1.
224. Dodd-Frank, *supra* note 1, at 763.
225. *See* Dodd-Frank, *supra* note 1.
226. Dodd-Frank, *supra* note 1, at 764.
227. *See* Regulatory Capital Rules, *supra* note 4, at 2.
228. *See id.* at 19.
229. *See id.*
230. *See generally* THE WHITE HOUSE, *supra* note 156.
231. *See About Freddie Mac, supra* note 7.
232. *See id.*
233. *See* Dodd-Frank, *supra* note 1, at 763.
234. *See About Freddie Mac, supra* note 7.

capital, it is no longer accountable for the loan.[235] Now the success or failure of the borrower to pay off the loan becomes the responsibility of the GSE.[236] As a result, the bank effectively circumvents the capital conservation requirements set by the Federal Reserve.[237]

It is unlikely that the loophole of the "revolving door" lending mechanism can be completely closed. However, it is possible to change lending and regulatory requirements by assigning accountability to ensure financial stability and consumer protection.[238] An effective way to do this would be to focus on the borrower and assess the borrower's risk through the duration of the loan. This would not only require banks to be more diligent in assessing a borrower's risk, but it would also ensure that the GSEs purchase quality mortgages that will perform through the duration of the loan. In turn, there would be fewer foreclosures and banks would be incentivized by the loan's positive performance to keep more profit generating debt.

The first task would be to establish a governing body that can address mortgage lending concerns while understanding bank capital conservation requirements. This is necessary to establish accountability, through the use of an enforcement entity. The second task would be to establish new underwriting requirements. Although many of the requirements can stay the same, there should be additional requirements which will assist in determining the lifetime performance of the loan.[239] One of the factors that should be included in the risk assessment process is the borrowers earning potential. This would require banks to examine not only the last two years of a borrowers employment, but go back as far as reasonably necessary to establish a trend.[240]

Things the underwriter out to consider are a borrower's level of education, length of past employment, and financial habits, such as regularly depositing money into a savings account. By assigning numerical values to these data sets, it would be possible to create a projection of the borrower's earning potential. Although a borrower's education level would be a factor, it would not be a discriminatory factor because it would be taken together with all the other data points. For example, if a borrower only finished high school, but owns a successful business, it would balance out the data points to create a true value of earning potential.

Another factor that should be included in the risk assessment process is job security. Again, there should be a number of data sets. These data sets, however, would reflect industry performance in the locale of the borrower. [241] By analyzing industry performance and projected growth, the lender could expand the borrower's likelihood of repaying the loan to cover the entire duration of the loan. Although it would be difficult to predict how a particular industry will do in the future, it would be helpful to analyze historical industry performance and correlations to the unemployment rate in that industry.[242] By doing so, a true value can be determined to represent the borrower's job security.

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[235] *See id.*

[236] *See id.*

[237] *See* Regulatory Capital Rules, *supra* note 4 (as soon as the bank sells of the loan, it no longer has the need to balance the debt against its capital).

[238] *See* Dodd-Frank, *supra* note 1.

[239] *See Underwriting Resources*, *supra* note 122.

[240] *See id.*

[241] *See generally* O*NET, *supra* note 164.

[242] *See id.*

Taken together with the borrowers earning potential, these metrics would lead to greater predictability of loan performance. These factors should not necessarily be given the most weight. The current underwriting process calls for evaluating a borrower's income for the past two years, current and pending debt, as well as total savings.[243] These are all important data points that must continuously be given significant weight.[244] However, by including the proposed factors in determining risk, a lender would have the ability to see past the borrower's short-term risk and take into consideration potential future performance.

This helps solve the problems of accountability and capital conservation. It allows for the Government to continue promoting its policy favoring homeownership. Additionally, it acknowledges the fact that banks circumvent the capital conservation requirements set by the Federal Reserve by selling their debt to the GSEs. [245] It also limits the risk of outstanding mortgages owned by the GSEs by limiting the automation of the underwriting process, instead creating an analytical framework that must be followed. By pegging industry performance to a borrower's personal profile, this framework can help prevent foreclosures and poor performance of mortgage instruments. Additionally, this framework would allocate more accountability to the banks by forcing them to use more in-depth metrics to determine loan performance. This stricter process for evaluating loans will also help increase consumer confidence by assuring people that long-term risk has been taken into consideration, before allowing a borrower to take on the substantial burden of mortgage payments.

This framework will help meet the goals of Dodd-Frank by addressing the need for financial stability and consumer protection.[246] It factors in the ability of banking institutions to bypass the Federal Reserve's implementation of Basel III capital conservation requirements.[247] Instead of allowing the GSEs to control the underwriting guidelines, it forces banks to be responsible not only to the GSEs, but to borrowers and investors. Basel III alone cannot take into account the need for lending and how the GSEs "revolving door" policy affects a bank's capital conservation requirements.[248] Nor can Dodd-Frank seek to protect the public from another subprime mortgage crisis without taking into account the risks of lending.

By creating a framework that takes both Basel III and Dodd-Frank into consideration and focuses on the borrower in combination with the lender, it is possible promote financial stability and consumer protection.[249] Financial institutions operating under this framework will still have to meet the capital conservation guidelines set forth by Basel III. However, they will no longer receive "blank checks" from the GSEs to maintain their capital conservation requirements. Instead, they will have to address the true purpose of Dodd-Frank by ensuring that borrower has the means and opportunity to repay his or her loans. This will protect the GSEs from taking on bad debt and provide for long-term financial stability.

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[243] *See Underwriting Resources*, *supra* note 122.

[244] *See id.*

[245] *See* Regulatory Capital Rules, *supra* note 4, at 19.

[246] *See* Dodd-Frank, *supra* note 1.

[247] *See* Regulatory Capital Rules, *supra* note 4 at 14.

[248] *See About Freddie Mac*, *supra* note 7.

[249] *See* Dodd-Frank, *supra* note 1.

IX. CONCLUSION

The adoption of Basel III by the Federal Reserve does not properly address the need for financial stability and consumer protection as set forth in Dodd-Frank. Basel III fails to take into account the impact lending has on banking regulations. Consumer lending is a fundamental part of the modern economic market. Consumer lending, theoretically, should lead to economic stimulus by increasing consumer spending. By not addressing the fundamental problems associated with consumer risk, Basel III lacks the necessary protection to prevent another financial crisis. Although Basel III does put an emphasis on bank capitalization and the need for accounting risk-weighted assets, it does not do enough for the long-term. Even if a bank is properly capitalized on paper, by continuing to lend money and subsequently selling the loans to Fannie Mae and Freddie Mac, the bank is still able to keep the necessary ratios while having a "revolving door" of loan applications. It can be argued that mortgage guidelines have become stricter and banks are no longer arbitrarily lending to consumers who lack the necessary financial foundation, but that is not to say that these mortgages are "prime."

The nature of the market in responding to regulations is too slow and cannot simply be fixed by adopting Basel III as a result. If consumers lack job security and the mortgage guidelines only require proof of *current* employment, it is a realistic problem that the consumer may lack the funds to pay the mortgage at any point after getting approved for it. With the mortgage being held by the GSEs, the bank is capable of lending more money, while the GSEs have to answer for any "subprime" loans they have on their books. As a policy matter, the lending guidelines cannot be too extreme, otherwise it will undermine the "American Dream," but at the same time, just setting capital conservation requirements that banks have to adhere to does not solve the long-term problem of the need for financial stability and consumer protection. The Federal Reserve should put more emphasis on controlling bank lending practices and monitoring the selloff of loans to other institutions. Simply having a capital conservation buffer only gives banks an obstacle, not a permanent barrier to another financial crisis.

A possible solution is to put more emphasis on the borrowers' earning potential and job security by factoring in a number of risk factors to determine the performance of the loan through its complete term. To ensure financial stability and consumer protection, lawmakers must focus on the regulation of bank capital conservation requirements, true consumer risk, industry performance and subsequent sale of the loan. The Federal Reserve's adoption of Basel III cannot possibly address this need by simply focusing on capital conservation, and therefore, cannot properly address the need for financial stability and consumer protection as set forth in Dodd-Frank. Instead, keeping in mind the continued need for consumer lending, the most effective solution is to focus on financial and banking reform through the mortgage framework. This can be done by focusing on the borrowers risk through the lifetime of the loan, and not just using a current snapshot of the borrower's financial security at the time the loan is approved.

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