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Disquiet on the Home Front: Disturbing Crises in the Nation's Markets and Institutions

Shelby D. Green
Pace University School of Law, sgreen@law.pace.edu

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INTRODUCTORY ARTICLE

Disquiet on the Home Front: Disturbing Crises in the Nation's Markets and Institutions

Shelby D. Green*

Crises are everywhere—in the housing market, in the financial markets and in the courts. It is difficult to exaggerate how large these crises are. It began with housing, but the effects dominoed throughout the economy. Consumer wealth evaporated. Developers watched rents fall and financing costs rise. Businesses contracted or dissolved. Exports plunged. Indeed, the Director of National Intelligence recently declared that the greatest threat to our national security is economic instability.[1] The main line of defense against recession—the Federal Reserve—seems to be at wits end.[2] All the usual responses have been tried and have failed: the federal interest rate has been cut to nearly zero and billions of dollars in loans continue to be pumped into the economy.[3] Even the drastic

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* Associate Professor of Law and Director, LL.M. Program in Real Estate Law, Pace University School of Law. J.D., Georgetown University Law Center, B.S., Towson State College. This Article will introduce the topics discussed in this edition of the PACE LAW REVIEW from the symposium, *Real Property, Mortgages, and the Economy: A Call for Ethics and Reforms*, presented jointly by the PACE LAW REVIEW and the Pace University School of Law, L.L.M. Program in Real Estate Law.

1. Stephen Manning, *Experts: Financial Crisis Threatens U.S. Security*, ABCNEWS.COM, Mar. 11, 2009, http://abcnews.go.com/Business/wireStory?id=7056044.

2. *See* Louis Uchitelle, *Wall Street Questioning if Bernanke is Tough Enough*, N.Y. TIMES, Jan. 10, 2008, at C1.

3. Ben Bernanke, Chairman, Federal Reserve, Address at the Women in Housing and Finance and Exchequer Club Joint Luncheon: Financial Markets, the Economic Outlook, and Monetary Policy (Jan. 10, 2008).

bailout plan,[4] involving the appropriation of $700 billion to buy troubled assets or preferred stock in troubled banks, has not sparked the economy. While almost too much has been written about our nation's current economic woes, some recurring themes have emerged.

I. Crisis in the Housing Markets

A long-standing and laudable national goal has been to increase home ownership in the United States to its maximum possible level, which should thus lead to an accumulation of wealth and security throughout the nation.[5] This goal has served as the outward premise for various national programs and policies.[6] In fact, in 2003, home ownership reached a historic peak of just under seventy percent of all households.[7] This was a significant increase over the forty-four percent rate in 1934, when the first federal program was established to realize this goal.[8] Some critics, however, have asserted that

4. *See infra* notes 109-13 and accompanying text.

5. *See* Paul Krugman, *Home Not-So-Sweet Home*, N.Y. TIMES, June 23, 2008, at A21.

6. The list of these national programs is indeed extensive, however particularly prominent features include the deductibility from taxable income of mortgage interest, *see* 26 U.S.C. § 163(h)(3)(A)(i) (2006), and the creation of the Federal Housing Administration ("FHA") to provide insurance to lenders and to permit leveraging of ninety-seven percent on FHA loans, *see* 12 U.S.C. § 1709(b)(9)(A) (2006) (requiring homeowners to make a 3.5% down payment). *See also* The Community Reinvestment Act of 1977, Pub. L. No. 95-128, § 801, 91 Stat. 1111 (codified as amended in scattered sections of 12 U.S.C.); OFFICE OF POLICY DEV. & RESEARCH, U.S. DEP'T OF HOUS. & URBAN DEV., U.S. HOUSING MARKET CONDITIONS: 3D QUARTER 1 (2006), *available at* www.huduser.org/periodicals/ushmc/fall06/Q306_summary.pdf; Vernon L. Smith, *The Clinton Housing Bubble*, WALL ST. J., Dec. 18, 2007, at A20 (mocking various governmental policies, including reduced capital gains tax rate, funding mortgages by federally-chartered agencies, and short-sighted federal reserve policies as causing the housing bubble now exploding); *infra* note 109 and accompanying text (discussing the implicit Federal Government guarantee of Fannie Mae and Freddie Mac).

7. *See* Dean Baker, *Subprime Borrowers Deserve an Own to Rent Transition*, ECONOMISTS' VOICE, Feb. 2008, at 2, *available at* http://www.bepress.com/ev/vol5/iss1/art5 (follow "Download"). *See also* OFFICE OF FED. HOUSING ENTERPRISE OVERSIGHT ("OFHEO"), REPORT TO CONGRESS 5 (2008), *available at* www.fhfa.gov/webfiles/2097/OFHEOReporttoCongress2008.pdf.

8. *See* U.S. Census Bureau, Historical Census of Housing Tables, http://www.census.gov/hhes/www/housing/census/historic/owner.html (last

these national policies, particularly the deductibility of mortgage interest and government insurance of mortgage loans, have distorted the markets and subsidized risk-taking by encouraging borrowers to increase their mortgage leverage and lenders to decrease their caution.[9] The immediate result was a rising housing market.[10] "From 1995 to 2006, house prices rose by almost eighty percent after adjusting for inflation,"[11] compared to the century from 1895 to 1995, when house prices rose at almost the same rate as inflation.[12] The bubble-inflated prices of recent years facilitated a level of construction that was far greater than what the ranks of

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visited Oct. 28, 2009); *infra* notes 128-33 and accompanying text.

9. *See* Posting of Edward L. Glaeser, Killing (or Maiming) a Sacred Cow: Home Mortgage Deductions, Economix, http://economix.blogs.nytimes.com/2009/02/24/killing-or-maiming-a-sacred-cow-home-mortgage-deductions/ (Feb. 24, 2009, 07:40 EST). *See also* Steven A. Holmes, *Fannie Mae Eases Credit to Aid Mortgage Lending*, N.Y. TIMES, Sept. 30, 1999, at C2. Lenders used the national goal of homeownership cynically, or perhaps in an act of self-deception, as they relied heedlessly on models instead of the actual circumstances of the borrower and the world in lending. NIALL FERGUSON, THE ASCENT OF MONEY 268-69 (2008). The model allowed them to relax underwriting standards (including foregoing documentation of assets and income, as well as high leveraging) partly because of the real property collateral and the recognition that low-income borrowers often had undocumented income. *Id.* at 269. Lenders could minimize the increased risks by raising interest rates and shifting the risk of inflation through adjustable rate mortgages. *Id.* at 264-65. Most significantly, lenders could pass on most of the risks through a sale of the mortgages in pools on the secondary market. *Id.* at 268-69. The secondary mortgage market is a market where existing mortgages are bought and sold. *See* Daniel J. McDonald & Daniel L. Thornton, *A Primer on the Mortgage Market and Mortgage Finance*, 90 FED. RESERVE BANK OF ST. LOUIS REV. (PART I) 31, 31-45 (2008). At first, two privately owned, yet government-sponsored entities, Fannie Mae and Freddie Mac, issued debt and used the proceeds to purchase mortgages in the secondary market. *See generally* Robin Paul Malloy, *The Secondary Mortgage Market: A Catalyst For Change in Real Estate Transactions*, 39 S.W. L.J. 991 (1986). In recent years, private investment entities have also entered the secondary market. *See* SHARON L. STARK & BARBARA F. BUCKLEY, OFFICE OF THRIFT SUPERVISION, MONTHLY MARKET MONITOR 6 (July 2008), *available at* http://files.ots.treas.gov/131013.pdf.

10. *See* Glaeser, *supra* note 9.

11. Baker, *supra* note 7, at 1. Indeed, in 2001, the average price of a home exceeded all the highest prices. *See* OFHEO, *supra* note 7, at 3. In 2006, the average price was nearly twice the average price less than ten years earlier. *See id.* at 5.

12. Baker, *supra* note 7, at 1.

prospective home-buyers could absorb.[13]

High leveraging by poor credit risks in real estate markets, however, promoted instability in both the housing and financial markets.[14] These highly-leveraged homeowners could not

13. *See* David Brooks, *The Bailout Artists*, N.Y. TIMES, Mar. 18, 2008, at A23.

14. These highly-leveraged borrowers make up in large measure what is referred to as the "subprime market." It is primarily characterized as consisting of borrowers with relatively low credit scores (620 compared to the medium score in the country of 723). *Characteristics of Subprime Lending Market Generally*, Subprime Lending: An Update of the Issues and Approaches (MB) § 2, at 3-4 (2007). These borrowers also borrow on a loan-to-value ratio greater than eighty percent. *Id.* As such, they posed the greatest risk, with their great prospect of being unable to carry their debt. To minimize some of this risk, these loans involve a balloon payment of principal, and are often coupled with negative amortization that adds accrued but unpaid interest to the debt. This means that the principal is not being reduced on a regular basis. These borrowers are enticed into these loans by the promise of the possibility of repayment on sale or refinancing at a higher price. The most common type of subprime mortgage, the so-called 2/28 loans, start out at below-market "teaser" rates fixed for two years, and are then adjusted in accordance with some index for the remaining twenty-eight year term. Once the teaser period expired, many borrowers were unable to carry the adjustable interest payments when overall interest rate levels did not remain low. With the decline in housing prices, these borrowers were unable to refinance their unwise loans. There is approximately $1.3 trillion of subprime mortgage debt outstanding, and approximately twenty percent of current, outstanding home mortgages are subprime. *See* Amy Crews Cutts, Deputy Chief Economist, Freddie Mac, Address at the Mortgage Bankers Association, 2008 Document Custody Conference (Sept. 22, 2008), *available at* http://www.mortgagebankers.org/files/Conferences/2008/DocumentManagementandCustodyConf08/DMC08SEPT25AmyCuttsMarketUpdate.pdf. The great bulk of the subprime loans were borrowed in 2005 and 2006, at the height of the housing boom. *Id.* Almost two-thirds of these loans have been packaged into mortgage-backed securities. *See* ADAM B. ASHCRAFT & TIL SCHUERMANN, FED. RESERVE BANK OF N.Y., STAFF REPORTS: UNDERSTANDING THE SECURITIZATION OF SUBPRIME MORTGAGE CREDIT 2 (2008), *available at* http://www.newyorkfed.org/research/staff_reports/sr318.pdf. The related Alt-A market is also suffering. The "Alt-A" mortgage market is made up of borrowers who may be self-employed, with a reasonable credit standing, but who have unsteady income. *Finance and Economics: Move Over, Subprime; Mortgage Losses*, ECONOMIST (London), Feb. 7, 2009, at 63, 63. The same lax lending practices that characterized the subprime market, applied equally to the Alt-A market: scant documentation and risky, negative-amortization mortgages. "According to the Bank for International Settlements, a staggering 40% of American mortgages originated in the first quarter of 2007 were interest-only or negative-amortization loans." *Id.* As the risks were great, "[d]elinquencies rocketed in the final months of 2008." *Id.* The sharp drop in house prices has sent half of all Alt-A borrowers into negative equity. *Id.* Moody's "quadrupled its loss projections on bonds backed by such loans:

normalize their borrowing status through refinancing because their property lacked equity, and thus they defaulted. These defaults prompted a tsunami: defaults in the investment-grade mortgage-backed securities ("MBS")[15] and AAA-rated securities were downgraded; investors became jittery; the price of debt securities began to fall; firms had to mark them to market[16] and put up more cash by selling more securities; market prices plunged; banks and other financial institutions wrote down the value of their MBS; and market prices fell below the intrinsic value of the underlying assets.[17]

There continues to be a debate as to whether the brisk pace of the subprime market caused the collapse of the housing market, or whether the decline in housing prices was a normal cycle in the movement of the market in general.[18] Regardless, it is undeniable that the multitude of highly-leveraged borrowers is an essential factor in the chain of events that have roiled both the national and international economies of late.[19]

As the housing market has cooled and as housing prices have fallen, the national and international effects are stark and multifarious. In some areas, the fall has been precipitous. For instance, in Detroit, Las Vegas, and Miami, prices have dropped at double-digit annual rates.[20] Those in economic

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of the $59 billion of AAA-rated securities that Moody's cut between January 29th and February 2nd, 91% went straight to junk." *Id.*

15. Mortgage-backed securities are instruments based upon "pools" of mortgages. *See* U.S. Securities and Exchange Commission, Mortgage-Backed Securities, http://www.sec.gov/answers/mortgagesecurities.htm (last visited Aug. 11, 2009).

16. To "mark to market" means to write down the value for an asset to reflect the prevailing market price. *See S.E.C. Elects to Keep Mark-to-Market Rules*, N.Y. TIMES, Dec. 31, 2008, at B2.

17. Paul Mizen, *The Credit Crunch of 2007-2008: A Discussion of the Background, Market Reactions, and Policy Responses*, 90 FED. RESERVE BANK OF ST. LOUIS REV. (PART I) 531, 533 (2008).

18. *Id.* at 531-33.

19. *See The Causes and Effects of the Lehman Brothers Bankruptcy: Hearing Before the H. Comm. on Oversight and Government Reform*, 110th Cong. 26-30 (2008) (statement of Robert F. Wescott, President, Keybridge Research LLC), *available at* http://oversight.house.gov/documents/20081010150253.pdf (unofficial transcript).

20. From August 2007 through August 2008, housing prices declined by twenty-eight percent in Miami, seventeen percent in Detroit, and thirty-one percent in Las Vegas. *See* SHARON L. STARK & BARBARA F. BUCKLEY, OFFICE OF THRIFT SUPERVISION, MONTHLY MARKET MONITOR 5 (Oct. 2008), *available*

distress and who have mortgages under water have been forced to sell their homes at substantial losses, or else risk foreclosure.[21] Moreover, the estimated number of foreclosures is expected to range wildly, from four to five million, through 2010, absent drastic intervention.[22] Borrowers and lenders could voluntarily work out a compromise, but subprime mortgage holders often insist on foreclosure.[23] As of the fourth

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at http://files.ots.treas.gov/131015.pdf.

21. The percentage of sales attributable to foreclosure rose sharply between July 2007 and July 2008. *See* TOM DAY, ZHONG YI TONG & DAVE MALMQUIST, OFFICE OF THRIFT SUPERVISION, MONTHLY MARKET MONITOR 7 (Nov. 2008) [hereinafter DAY, YI TONG & MALMQUIST, Nov. 2008], *available at* http://files.ots.treas.gov/131016.pdf. In Miami, the foreclosure rate was fourteen percent, in Phoenix it was thirty-three percent, and in Los Angeles it was thirty-four percent. *Id.* In 2008, a record 1.6 million homeowners lost their homes to foreclosure. *Priorities for the Next Administration: Use of TARP Funds Under EESA: Hearing Before the H. Comm. on Financial Serv.*, 111th Cong. (2009) [hereinafter *Priorities*] (statement of John F. Bovenzi, Deputy to the Chairman and Chief Operating Officer, Federal Deposit Insurance Corporation ("FDIC")), *available at* http://www.house.gov/apps/list/hearing/financialsvcs_dem/bovenzi011309.pdf. In 2009 and 2010, an estimated five million more homeowners will lose their homes. *Id.* "As of the third quarter of 2007, approximately 16% of outstanding subprime mortgages [were] in default, and almost 7% [were] in foreclosure—rates far higher than for prime home mortgages." Philip R. White & James M. Hirschhorn, *What the "Subprime Crisis" Really Means for Your Business*, METROPOLITAN CORP. COUNS., Jan. 2008, at 20, *available at* http://www.metrocorpcounsel.com/pdf/2008/January/20.pdf. In September 2008, these figures had risen: approximately 24% of mortgages were in default and 11.5% in foreclosure. TOM DAY, ZHONG YI TONG & DAVE MALMQUIST, OFFICE OF THRIFT SUPERVISION, MONTHLY MARKET MONITOR 11 (Dec. 2008), *available at* http://files.ots.treas.gov/1310171.pdf. In November 2008, the percentage of seriously delinquent subprime mortgages rose to 42.5%. SHARON STARK, ZHONG YI TONG & JONATHAN JONES, OFFICE OF THRIFT SUPERVISION, MONTHLY MARKET MONITOR 8 (Jan. 2009), *available at* http://files.ots.treas.gov/131018.pdf.

22. *See Oversight of Implementation of the Emergency Economic Stabilization Act of 2008 and Efforts to Mitigate Foreclosures: Hearing on the Housing Crisis Before the Subcomm. on Financial Serv. and the General Government of the S. Comm. on Appropriations*, 110th Cong. (2008) (statement of Michael Krimminger, Special Advisor for Policy, Office of the Chairman, FDIC), *available at* http://appropriations.senate.gov/ht-financial.cfm (follow "Testimony of Michael Krimminger of the FDIC at the Dec 4 Housing Crisis Hearing"); *Priorities*, *supra* note 21 (statement of John F. Bovenzi, Deputy to the Chairman and Chief Operating Officer, FDIC) (predicting that 4 to 5 million foreclosures will occur within the next two years without government intervention).

23. *See* EDWARD VINCENT MURPHY, CONG. RESEARCH SERV., REPORT FOR CONGRESS: ECONOMIC ANALYSIS OF A MORTGAGE FORECLOSURE MORATORIUM 9-10 (2008).

quarter of 2008, the rate of homeownership declined to 67.5%, which is 1.3% below its peak of four years earlier, and its lowest level since the first quarter of 2001.[24] The effects of the crisis are felt more sharply by certain populations within our society. For instance, the homeownership rate for African-Americans stood at 46.7% in the third quarter of 2008—3% below its peak level reached in the third quarter of 2004.[25]

Foreclosures depress the housing market, leading to more foreclosures and inevitably resulting in net losses to lenders,

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24. *See* U.S. Census Bureau, Housing Vacancies and Homeownership—Fourth Quarter 2008: Table 5, http://www.census.gov/hhes/www/housing/hvs/qtr408/q408tab5.html (last visited Aug. 11, 2009). *See also* 2008 OFFICE OF FED. HOUS. ENTER. OVERSIGHT, ANNUAL REPORT 5, *available at* http://www.fhfa.gov/webfiles/2097/OFHEOReporttoCongress2008.pdf (reporting that "[t]he national homeownership rate declined from 68.9 percent at the end of the fourth quarter of 2006 to 67.8 percent one year later—the lowest level since the second quarter of 2002") (the agency has since been renamed the Federal Housing Finance Agency).

25. *See* Baker, *supra* note 7, at 2. In fact, the evidence shows that African-American and Hispanic homeowners over the age of 50 experienced higher rates of foreclosure than Caucasian homeowners in all age groups, and roughly double their rate of homeownership. "Older African-American homeowners held 6.8 [percent] of all first mortgages, but represented only 14.4 percent of all foreclosures; while Hispanic homeowners aged 50 and older held 7.5 percent of first mortgages, but represented 15.9 percent of all foreclosures . . . ." *Helping Families Save Their Homes in Bankruptcy Act of 2009* and *Emergency Home Ownership and Protection Act: Hearing on H.R. 200 and H.R. 225 Before the H. Comm. on the Judiciary*, 111th Cong. 3 (2009) (testimony of David M. Certner, Legal Counsel and Legislative Policy Director, Association for the Advancement of Retired Persons), *available at* http://judiciary.house.gov/hearings/pdf/certner090122.pdf.

> Having a subprime loan was found to be associated with higher foreclosure rates for all age groups, but the impact of subprime lending was disproportionately greater for older homeowners[.] Homeowners age 50 and older . . . [were] nearly 17 times more likely to be in foreclosure than homeowners of the same age with prime loans . . . .

Id. *See also* Rick Brooks, *Subprime Debacle Traps Even Very Credit-Worthy*, WALL ST. J., Dec. 3. 2007, at A1. Although this is hotly disputed by lenders, the Wall Street Journal cited allegations that some such borrowers were steered into subprime loans by brokers and lenders whose commission structures gave them an incentive to market loans bearing higher interest rates. Brooks, *supra*. In addition, the proportion of non-white borrowers who obtained subprime loans is substantially higher than the proportion of white borrowers. *See* Ruth Simon, *Illinois Probes Mortgage Firms*, WALL ST. J., Mar. 7, 2008, at A3.

since these forced sales commonly net only fifty to sixty-five percent of the property's real value.[26] Recent housing inventory statistics show record or near record levels of homes on the market.[27] The current vacancy rate of 2.7 for ownership units is more than forty percent higher than the level reached in any prior housing drop.[28] Excessive supply, working in tandem with high foreclosure rates, will accelerate the downward pressure on housing prices.[29] It was predicted that home prices would continue to decline through 2009, with stabilization and recovery beginning in 2010.[30] Added to these losses are increased costs to local governments that provide emergency shelter and social services to the newly homeless and neighboring owners.[31]

While mortgage default rates have risen dramatically over the past three years across all borrower and interest rate types, the most dramatic increase has occurred in subprime loans.[32] The vintage of the loan was also a significant factor in loan performance.[33] Additionally, in terms of the severity of the

26. STARK, YI TONG & JONES, *supra* note 21, at 8. *See also* Amy Crews Cutts & William A. Merrill, *Interventions in Mortgage Default: Policies and Practices to Prevent Home Loss and Lower Costs*, at Table 8, Figures 5, 7, App'x A1 (Freddie Mac, Working Paper No. 08-01), *available at* http://www.clevelandfed.org/Our_Region/Community_Development/pdf/interventions_in_mortgage_default_Frank.pdf.

27. DAY, YI TONG & MALMQUIST, Nov. 2008, *supra* note 21, at 5. *But see* STARK, YI TONG & JONES, *supra* note 21, at 6 (showing a twenty-seven percent decline in inventory of existing and new homes between August and November 2008).

28. *See* Baker, *supra* note 7, at 2.

29. *See id.*

30. *See* DAY, YI TONG & MALMQUIST, Nov. 2008, *supra* note 21, at 6. *See also* SHARON L. STARK & ZHONG YI TONG, OFFICE OF THRIFT SUPERVISION, QUARTERLY MARKET MONITOR 4-5 (May 2009), *available at* http://files.ots.treas.gov/131020.pdf (showing an 11.5% decline in home prices from one year earlier, and a more than 30% decline since the peak in mid-2006).

31. The cost associated to both the Federal Government and taxpayers in addressing this crisis nationwide is discussed throughout the Article.

32. *See* Amy Crews Cutts, *supra* note 14 (reporting that the rate of default on subprime adjustable rate mortgages was 20 times higher than the rate of default on prime fixed rate mortgages, and that subprime loans accounted for over half of foreclosures begun since 2006).

33. The year 2007 had the worst overall loan performance, as compared to 2006, 2005, and 2004, respectively. *See* SHARON L. STARK & ZHONG YI TONG, OFFICE OF THRIFT SUPERVISION, MONTHLY MARKET MONITOR 8 (May 2009), *available at* http://files.ots.treas.gov/131020.pdf.

losses that occurred, subprime loans were the most costly.[34]

It appears that the effect of pushing so many moderate income families into homeownership on any terms in the bubble-inflated market of the last few years was a cruel play, a set-up to foreclosure and the loss of many families' homes. What was once thought to be the achievement of the "American dream" is now a nightmare—"not an obvious route . . . [to] wealth."[35] Indeed, the statistics reveal that it was all just about the money, the profits from high-rate loans, and nothing more.[36]

II. Crisis in the Financial Markets

In a single month in 2008, the Dow Jones Industrial Average lost 1,514 points, reflecting price movements ranging between 2,937 points.[37] In that same month, the Chicago Board Options Exchange Volatility Index ("VIX") reached an

34. As of November 2008, subprime loans sustained 62.3 cents on the dollar, followed by option ARMs at 52.3 cents, Alt-As at 51.2 cents, and jumbo loans at 37.2 cents. *Id.* at 7-8. In regards to vintage, 2007 subprime loans sustained the highest, relative to 2006, 2005, and 2004 respectively. *Id.* at 7.

35. Baker, *supra* note 7, at 2.

36. Yet swift ride of the loan originators has also come to an abrupt halt. Several of the top loan companies have suffered massive losses. Countrywide Financial lost $893 million in the first quarter of 2008, the third consecutive quarterly loss for the nation's largest mortgage lender and loan servicer. *See Countrywide Says it Lost $893 Million in Quarter*, N.Y. TIMES, Apr. 30, 2008, at C4. This was a drastic decrease in comparison to Countrywide's earnings of $434 million just a year earlier. *Id.* In 2008, Countrywide had "charge-offs," or loans written off as not repaid, which totaled $606 million, as opposed to $39 million in 2007. *Id.* In addition, delinquencies in Countrywide's servicing portfolio doubled in 2008, up to 9.3 percent from 4.8 percent in 2007. *Id.* All the while, loan applications continued to rise by more than 27 percent, totaling $2.2 billion. *Id.* On January 4, 2009, Countrywide agreed to be purchased by Bank of America at a price of $4 billion. *See* Gretchen Morgenson, *Countrywide's Buyer Isn't Blinking*, N.Y. TIMES, June 8, 2008, at BU1. Additionally, early in 2008, IndyMac Bancorp reported sharp increases in delinquencies and foreclosures, which resulted in its stock price falling $1.23 per share. *Thornburg, A Mortgage Lender, Misses Margin Calls*, N.Y. TIMES, Mar. 4, 2008, at C3. The number of delinquencies on the loans it serviced, specifically those loans at least thirty days past due, "rose to 7.79 percent in January from 7.50 percent in December and 4.37 percent in the first quarter of 2007." *Id.* Delinquencies among prime loans rose to 6.85 percent, up from 3.83 percent in 2007. *Id.* Subprime mortgage delinquencies rose to 28.18 percent, up from 18.55 percent a year earlier. *Id.*

37. *See* DAY, YI TONG & MALMQUIST, Nov. 2008, *supra* note 21, at 1.

all-time high of 80.1%.[38] The year 2008 can also be remembered for the collapse and disappearance of venerable banks and financial institutions: Bear Stearns (bought out by J.P. Morgan Chase),[39] Merrill Lynch (bought by Bank of America),[40] Lehman Brothers (filed for bankruptcy),[41] Wachovia Bank (bought by Wells Fargo)[42] and Countrywide Financial, the country's largest loan originator (bought by Bank of America).[43] The Federal Deposit Insurance Corporation ("FDIC") took over many banks that had over-extended themselves, such as IndyMac[44] and Washington Mutual.[45] These institutions had amassed so much debt that threatened to overwhelm them. That debt was largely from investments in the secondary market—that is, they bought and sold mortgage-backed securities.[46]

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38. *See* STARK, YI TONG & JONES, *supra* note 21, at 4. The VIX is sometimes referred to as the "fear index," although it measures volatility in either direction. *Id.* Another indication of turmoil in the market is changes in the LIBOR rate. *See id.* For example, the LIBOR rate rose from 2.15 percent on September 12, 2008, to 6.44 percent on September 16, 2008. *See* British Bankers' Association, Historic LIBOR Rates, Sept. 12, 15, 16, 2008 (on file with the British Bankers' Association and author).

39. *See* Robin Sidel, *J.P. Morgan Rescues Bear Stearns*, WALL ST. J., Mar. 17, 2008, at A1.

40. *See* Matthew Karnitschnig, *Bank of America to Buy Merrill*, WALL ST. J., Sept. 15, 2008, at A1.

41. *See* Andrew Ross Sorkin, *Bids to Halt Financial Crisis Reshape Landscape of Wall Street*, N.Y. TIMES, Sept. 15, 2008, at A1.

42. *See* Dan Fitzpatrick, *Wells Fargo Grabs Wachovia as Citi Walks*, WALL ST. J., Oct. 10, 2008, at C1.

43. *See* Morgenson, *supra* note 36. In addition, the American International Group ("AIG") was on the brink of collapse until rescued by the Department of Treasury.

44. *See* Louise Story, *Regulators Seize IndyMac After a Run on the Bank*, N.Y. TIMES, July. 12, 2008, at C1.

45. *See* Eric Dash & Andre Ross Sorkin, *In Largest Bank Failure, U.S. Seizes, Then Sells*, N.Y. TIMES, Sept. 26, 2008, at A1. In the FDIC Quarterly Banking Profile Report, in the third quarter of 2008, "expenses for credit losses topped $50 billion for a second consecutive quarter. . . . [T]hird quarter net income totaled $1.7 billion, a decline of $27.0 billion (94.0 percent) from the third quarter of 2007. . . . [A]lmost one in every four institutions (24.1 percent) reported a net loss for the quarter . . . ." 3 FDIC QUARTERLY BANKING PROFILE 1, at 1 (2008).

46. Securitization is the transformation of groups of similar kinds of receivables (credit card debt, leases, and mortgages, for instance) into securities that can then be sold to investors. For example, commercial loans can be converted into collateralized debt obligations ("CDOs"), which entitle the investors to receive specific cash flows generated by the loans. The pool

Mortgage-backed securities based on pools of mortgages have been safely sold since the conversion of Fannie Mae into a government-chartered private corporation and the creation of Freddie Mac and Ginnie Mae.[47] But, more recently, these securities became unduly risky when they became based on subprime mortgages.[48] In the past decade, market participants ignored these risks as they "discovered that cash flows from pools of mortgages could be structured so that one class of investors bore a minimal risk of default while others bore increasingly greater risk."[49] Because of this division of risk, "investment grade securities could be created," almost magically, "to finance mortgages for people who previously were not creditworthy."[50] Issuers of these securities promised a reduced risk from default on the underlying subprime mortgages by keeping:

> [A] margin between the amount of mortgages held by the pool and the amount of [securities] issued, by [setting] an interest rate spread between the mortgages and the [securities], and by various guarantees, insurance and hedging techniques. The remaining risk of default was allocated among different payment tranches, so that [the lowest price securities] would be exposed to the earliest defaults while the most secure would have priority over whatever payment came in. The most secure tranches were rated investment grade by the credit rating agencies, which made them eligible for purchase

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of mortgages underlying the security is often divided up into tranches, assigning various amounts of risks and returns, and making them suitable for a variety of different investors. The issuance of these securities provided liquidity to many different markets and spread the risk among the issuers and investors, as well as the borrowers on the other side. Issuers of the securities usually did this through special purpose entities or structured investment vehicles, whereby the underlying assets and their liabilities were reflected on different sets of books.

47. Lawrence J. White, *Fannie Mae, Freddie Mac, and Housing Finance: Why True Privatization is Good Public Policy*, 528 CATO INST. POLICY ANALYSIS 1, at 1 (2004), *available at* http://www.cato.org/pubs/pas/pa528.pdf.

48. White & Hirschhorn, *supra* note 21, at 20.

49. *Id.*

50. *Id.*

> by insurance companies and ERISA regulated pension funds. The less secure received speculative grade ratings and many were purchased and pooled as the basis for so-called collateralized debt obligations.[51]

All of the struggling institutions mentioned above[52] seemed to have been afflicted with the same malady: under-pricing of risk.[53] Perhaps this was due to the novelty of these securities.[54] But some economists say that mispricing risk occurs during both boom times and crashes, when rational thinking is overcome by greed and fear.[55] In a boom, over-confident investors take on bets that they later find themselves unable to discharge. In this crisis, the players made one-way bets—that the markets would only go up. They did not anticipate the "*black swans*" or the "*dragons*."[56]

In 1983, Ben Bernanke offered an analysis of the causes and effects of the Great Depression.[57] The current Chairman of the Federal Reserve then commented on the causality between adverse developments in the macroeconomy (or, declines in aggregate output) and bank failures, with respect to their coincidences and to the persistence of the relevant financial

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51. *Id.* CDOs are defined as mechanisms for converting mortgage securities and corporate bonds from large, illiquid assets into liquid financial instruments. *See* FDIC, *Enhancing Transparency in the Structured Finance Market*, SUPERVISORY INSIGHTS, Summer 2008, at 5-9, 13; Mizen, *supra* note 17, at 538. They are structured financial products, usually backed by pools of mortgages, and typically sliced into tranches with varying degrees of risk and projected returns. *See* FDIC, *supra*, at 5; Mizen, *supra* note 17, at 538.

52. *See supra* notes 39-45 and accompanying text.

53. *See generally* Joe Nocera, *Risk Mismanagement*, N.Y. TIMES MAG., Jan. 4, 2009, at 24.

54. *See* White & Hirschhorn, *supra* note 21, at 20.

55. CHARLES P. KINDLEBERGER & ROBERT ALIBER, MANIAS, PANICS AND CRASHES: A HISTORY OF FINANCIAL CRISES 36-39 (5th ed. 2005).

56. These unusual references stand for the unknown variables in risk calculations that take place more frequently than we are willing to contemplate. "Because we don't know what a black swan might look like or when it might appear and therefore don't plan for it, it will always get us in the end." Nocera, *supra* note 53, at 29. *See also In Plato's Cave*, ECONOMIST (SPECIAL REPORT) (London), Jan. 24, 2009, at 12, 14.

57. Ben S. Bernanke, *Nonmonetary Effects of the Financial Crisis in the Propagation of the Great Depression*, 73 AM. ECON. REV. 257, 258-63 (1983).

crisis.[58] There were arguments on both sides of this causality issue. One view was that the problems of the financial system had tended to lead to output declines; in fact, sources of financial panics unconnected with the fall in output have been documented by many writers.[59] The other view was that industrial production had begun to decline before the financial crisis set in.[60] While not taking a firm position on the causality issue, throughout his analysis, Bernanke stressed the importance of recognizing the role of exogenous events, which influence estimates of future cash flows and lead to endogenous changes in prevailing levels of risk adversity in the availability of credit and contractions in the money supply.[61]

Can Bernanke's insights explain the under-pricing of subprime risk? Could the liquidity of Asian and Middle Eastern investors be viewed as an exogenous factor? Or, could this under-pricing have been intentional and not the result of euphoria or ignorance? As the market for mortgages grew to include private entities—who bought, sold, and packaged mortgage-backed securities at a seemingly frenzied pace—the race was not only to the swift, but to the bottom as well. There was a "perverse incentive" operating.[62] The investment bankers knew or should have known in advance (after all, they have the knowledge and expertise) that "their time [would] run out and the [investment] fund [would] collapse."[63] The strategy they employed was "to maximize annual return," but only ostensibly.[64] Economist Anthony D'Amato describes the strategy in this way:

> Suppose [the bankers] are buying bundled mortgages. Someday, all the mortgages will collapse, but until they do the investor in the fund has no idea about the comparative risk

58. *Id.* at 261-63.
59. *See, e.g.*, *id.* at 267.
60. *Id.*
61. *See id.* at 271.
62. Anthony D'Amato, *Letter*: *Hedge Funds Race to the Bottom*, ECONOMISTS' VOICE, June 2008, at 1, *available at* http://www.bepress.com/ev/vol5/iss3/art1/ (follow "Download").
63. *Id.*
64. *Id.*

> between types of bundles. Thus the [banker] will simply buy the bundles that come on the market with the highest interest rate of return. (If the choice is between bundle A that contains mainly prime mortgages and pays 10%, and bundle B that contains nothing but the riskiest sub-prime mortgages and pays 14%, the [banker] need not engage in any qualitative calculations. He only needs to know that 14 is higher than 10.) Thus there is a race to the bottom. The worse and riskiest bundles (of mortgages or any other debt instruments such as car loans or credit cards) will attract the most investor money, keeping the game alive and compounding it. Fortunately for the [banker], he pays himself annually. (He also takes bonuses, which often exceed his payments for managing the fund.)[65]

The investment bankers had plausible deniability if this strategy failed—they could claim earnest and honest reliance on the evaluation of the ratings agencies. But this earnestness can now be seen through. The agencies also responded to the incentives inherent in the regulatory use of ratings.[66] The continued flow of business to the agencies depended upon their reports of acceptable ratings. In March 2008, the President's Working Group on Financial Markets, the two-decades-old committee representing the Treasury, the Federal Reserve, the Securities and Exchange Commission ("SEC"), and the

65. *Id.* In 2006, the CEOs of the big five investment banks, Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers, and Bear Stearns, took home a total of $166.4 million in bonuses. *See* KEVIN CONNOR, NAT'L TRAINING & INFO. CTR., ET AL., WALL STREET AND THE MAKING OF THE SUBPRIME DISASTER: HOW INVESTMENT BANKS FUELED THE SUBPRIME BOOM, MADE BILLIONS, AND CAUSED THE CURRENT FORECLOSURE CRISIS 6-7 (2007), *available at* http://subprimer.org/files/wall-street-and-the-making-of-the-subprime-disaster.pdf. In 2007, firm bonuses topped $38 billion. *Id.* at 25. *See also* David Weidner, *Making Greed Good*, WSJ.COM, Sept. 3, 2009, http://online.wsj.com/article/SB125189899520579603.html (reporting on executive compensation). These bonuses were made despite more than $50 billion write-downs by these companies. CONNOR, *supra*, at 22. In January 2009, it was discovered that as Merrill Lynch negotiated its takeover by Bank of America, it also paid out $4 billion in bonuses at the end of 2008. Dave Krasne, *Money for Nothing*, N.Y. TIMES, Jan. 27, 2009, at A31.

66. *See* ASHCRAFT & SCHUERMANN, *supra* note 14, at 12.

Commodity Futures Trading Commission, described the origins of the mortgage market fiasco in terms of the conflicts of interest between what economists call the "principals" (investors and home buyers) and their "agents" (mortgage brokers, securities brokers, and credit analysts).[67] Principals relied on agents to evaluate the risks on their behalf.[68] But the agents, whose income largely depended on the number of deals they put together, had powerful incentives to understate risk: they assumed unrealistically low expected losses on subprime pools and failed to revise their assumptions upwards, even in the face of rising defaults and changes in the population of loan originators and borrowers on the underlying instruments.[69] The estimates were low—not only as to their probability of default, but also as to the magnitude of the losses that would result.[70]

Could there have been too much reliance on mathematical models? Models that purported to manage risks—to capture the behavior of a market and to link an observable or illiquid price to prices in traded markets? The modeling became problematic when pools of mortgages were bundled up into collateralized debt obligations ("CDOs").[71] CDOs, because of their complex layering, became impossible to model in any but a most rudimentary way, largely because each contained a unique combination of assets.[72]

> Each CDO would be sold on the basis of its own scenario, using central assumptions about the future of interest rates and defaults to "demonstrate" the payouts over, say, the next 30

67. *See generally* THE PRESIDENT'S WORKING GROUP ON FIN. MKTS., POLICY STATEMENT ON FINANCIAL MARKET DEVELOPMENT (2008), *available at* http://www.ustreas.gov/press/releases/reports/pwgpolicystatemktturmoil_03122008.pdf [hereinafter POLICY STATEMENT]; THE PRESIDENT'S WORKING GROUP ON FIN. MKTS., PROGRESS UPDATE ON MARCH POLICY STATEMENT ON FINANCIAL MARKET DEVELOPMENTS (2008) [hereinafter PROGRESS UPDATE], *available at* http://www.ustreas.gov/press/releases/reports/q4progress%20update.pdf.

68. *See generally* POLICY STATEMENT, *supra* note 67; PROGRESS UPDATE, *supra* note 67.

69. *See* POLICY STATEMENT, *supra* note 67, at 14.

70. *Id.*

71. *See supra* notes 62-65 and accompanying text.

72. *See Greed—and Fear*, ECONOMIST (SPECIAL REPORT) (London), Jan. 24, 2009, at 4.

> years. This central scenario would then be "stress-tested" to show that the CDO was robust—though oddly the tests did not include a 20% fall in house prices.[73]

History is a dangerous basis for modeling.[74] The models also failed to take into account other critical variables, like falling underwriting standards (i.e., not requiring documentation or little documentation, and accepting low credit scores), and conflicts of interests affecting the ratings by credit ratings agencies.[75] It seems that corporate and mortgage-backed securities "were a leap in the dark," as no one knew what they were ignoring, and therefore failed to correct for any inadequacies in the model.[76]

The most prominent mathematical model employed was the "Value-at-Risk" model, built around long-standing statistical ideas and probability theories.[77] It purports to measure the boundaries of risk in a portfolio over short durations assuming a "normal" market, that is, to measure the potential losses of a portfolio, supposedly "to show whether banks and other financial outfits are being safely run. . . . [And] how much capital banks need to put aside for a rainy day."[78] For instance, if one has $50 million of weekly value at risk, that means that over the course of the next week, there is a 99 percent chance that one's portfolio won't lose more than $50 million.[79] That should provide a bit of comfort to the investor, particularly one whose investments are fairly diversified. But the essential and overwhelming flaw in the formula, one so large as to put into question its fundamental soundness, is that it only measures known risks, not "tail risks," that is, risks at

73. *In Plato's Cave*, *supra* note 56, at 13.

74. *Id.*

75. *Id.*

76. *Id.*

77. *Id.* The model was developed and popularized in the 1990s by "quants," short-hand for financial economists who apply quantification formulas for investment decisions. Nocera, *supra* note 53, at 26.

78. *In Plato's Cave*, *supra* note 56, at 13.

79. Nocera, *supra* note 53, at 29. For an example of miscalculations in 1998 by the hedge fund, Long-Term Capital Management, see FERGUSON, *supra* note 9, at 325-27. *See also infra* note 145 and accompanying text.

the extremes of investment decisions.[80] The model assumes a normal distribution of changes and risks in the market,[81] looking only to the short-term, and only a few years back, and does not distinguish between the leverage that comes from long-term fixed rate debt (such as bonds) and that from loans callable at any time.[82] What is not reported is the impact of the remaining one percent, or the "black swans" or "dragons."[83] It does not tell you, for instance, "[t]hat the $50 million [isn't] just the most one could lose 99 percent of the time. It [in fact] was the least you could lose 1 percent of the time."[84] Too much reliance on the fact of quantification, rather than on market observations and the not-so-distant historical trends, and too much absence of judgment are the essential culprits in this crisis.[85]

Even if the asset managers knowingly underpriced the risk, how could institutional investors have accepted the asset managers' assessments at face value—particularly with so little market history to examine—since subprime loans were, relatively speaking, a rather new investment tool? Only after 2006 did the subprime mortgage losses begin to rise dramatically.[86] The relatively low rate of losses occurred during a time of economic boom, where the probability of default and loss given default was expected to be low. If the investors had knowledge of the composition of the pool—i.e., that there was a greater percentage of higher-risk borrowers, with a greater percentage of adjustable rate mortgages—they might have suspected that under-pricing of risk was occurring.

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80. *See* Nocera, *supra* note 53, at 46.

81. The research, however, clearly shows that the market is wildly unstable. *See In Plato's Cave*, *supra* note 56, at 14 (describing a study by mathematician Benoît Mandelbrot, who invented the fractal theory).

82. *See* Nocera, *supra* note 53, at 29. In markets, extreme events are surprisingly common—the tails are "fat." *Id.*; *In Plato's Cave*, *supra* note 56, at 14.

83. *See* Nocera, *supra* note 53, at 29. *See also supra* note 56 and accompanying text.

84. Nocera, *supra* note 53, at 50.

85. *Id.* at 50. The use of these models in valuing MBS is in stark contrast to the method of valuing corporate debt, where the particulars of the institution are considered and evaluated. Mizen, *supra* note 17, at 541, 545.

86. SHARON L. STARK & ZHONG YI TONG, OFFICE OF THRIFT SUPERVISION, MONTHLY MARKET MONITOR 11, 14-15 (Mar. 2009), *available at* http://files.ots.treas.gov/131020.pdf.

Still the omens were apparent, as early as 2005, with evidence of mounting performance problems and calls for vigilance by economists[87]—but the originators kept writing loans, indeed at a feverish pace. Ratings agencies transparently understated risk and inflated the grading scale of their debt ratings for securitized products in order for institutional investors to invest and stay within their guidelines and regulations.[88] This occurred when the ratings agencies ceased to be dispassionate appraisers of the merits of the product, and instead, worked to reach a desired rating by participating in discussions about exactly how to design and structure the securities.[89]

While it was true that there were capital requirements in place, these requirements were either relaxed by the SEC, or evaded by conduits of MBS through the device of a structured investment vehicle.[90] Again, subterfuges and obfuscations were prevalent.

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87. *See generally* KRISTOPHER S. GERARDI ET AL., FED. RESERVE BANK OF BOSTON, MAKING SENSE OF THE SUBPRIME CRISIS (2009) (stating that, given the available data, market participants should have been able to understand that a fall in prices would have had disastrous consequences for the market, but instead, assigned a low probability to such an outcome); Paul Krugman, Op-Ed., *That Hissing Sound*, N.Y. TIMES, Aug. 8, 2005, at A15 (same); Robert J. Shiller, "*Irrational Exuberance"—Part 2*, MONEY, Feb. 2005, at 71 (same).

88. *See* William G. McGuinness & John W. Brewer, *Credit Ratings Agencies Under the Microscope*, N.Y. L.J., Jan. 5, 2009, at S6.

89. *See* POLICY STATEMENT, *supra* note 67, at 1-2; PROGRESS UPDATE, *supra* note 67, at 1-3.

90. In 2001, a new Treasury rule was adopted that essentially stated that when retaining a first-loss position in a securitization conduit, the sponsoring institution was required to maintain an equal amount of capital to the size of the retained position. However, this requirement could be circumvented through the device of a structured investment vehicle ("SIV"). *See* 12 C.F.R. pts. 3, 208, 225, 325, 567.1, 567.5, 567.6 (2009) (exempting conduit sponsors from newly enacted GAAP consolidation rules for securitization, which otherwise would have required securitized assets to be treated as on-balance sheet assets for purposes of calculating capital requirements). An SIV is an entity, typically a corporation or trust formed by investment banks, to sell or to hold mortgage-backed securities, owned by, but legally distinct from, the lender. Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Consolidation of Asset-Backed Commercial Paper Programs and Other Related Issues, 69 Fed. Reg. 44,908-01 (July 28, 2004). The SIV may resell the loan pools to a second SIV, which is also independent of the lender and takes title to the bundle. The second SPV is typically in the form of a trust. *See id.* A Treasury exemption made this ruse legal. *See id.*

III. Crisis in the Courts and Havoc With Land Titles

Many of the firms that profited from the subprime lending boom are now hobbling and experiencing severe losses as they are forced to contract. Many are insolvent. Many have seen their stock prices plummet. As one might expect, securities fraud claims have been filed against these firms and their directors and officers, charging, among other things, misrepresentation about the nature and quality of the assets underlying the securities, as well as breach of fiduciary duty in continuing to deal in the subprime market despite clear evidence of impending collapse.[91]

State court dockets have swelled with foreclosure complaints. State courts are the only venues for such relief, as foreclosures began in the early courts of equity where they gave mortgagors a right to redeem their property before foreclosure.[92] Federal bankruptcy courts, as homeowners and

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91. One study reports as many as 136 securities class action suits based on subprime losses filed as of early 2008. JENNIFER E. BETHEL ET AL., HARVARD LAW SCHOOL, LAW AND ECONOMICS ISSUES IN SUBPRIME LITIGATION 67-72 (2008), *available at* http://lsr.nellco.org/cgi/viewcontent.cgi?article=1400&context=harvard_olin. Other research suggests that the forty-three percent rise in securities violations cases in 2007 may have been attributable to the subprime mortgage crisis. *See* U.S. CHAMBERS INST. FOR LEGAL REFORM, SECURITIES CLASS ACTION LITIGATION 2, 5 n.7 (2008), *available at* www.instituteforlegalreform.com/get_ilr_doc.php?docId=1213. Nonetheless, shareholders seeking recovery against corporate officers and directors will be met with the almost insurmountable barriers of the Private Litigation Securities Reform Act of 1995, Pub. L. No. 104-67, § 101, 109 Stat. 737 (codified at 15 U.S.C. § 78u-4(b)(2) (2006)) (imposing heightened pleading requirements and requiring particularity on the element of scienter) and the Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (codified as amended in scattered sections of 15 U.S.C.) (asserting exclusive federal jurisdiction over federal securities litigation claims). To date, there has been at least one suit against an ERISA fiduciary that alleges breach of fiduciary duty by investing in subprime mortgage backed securities. *See generally* Thomas J. Hall & Thomas J. McCormack, *Financial Meltdown Triggers Litigation Wave*, N.Y. L.J., Jan. 5, 2009, at S2 (discussing the various kinds of suits filed, including misrepresentations by CDO issuers, securities fraud, funding suspension, unfair and defective practices against loan originators, and breach of fiduciary duty by corporate officers and directors); Manfred Ohrenstein & Matthew Bryant, *Subprime Litigation: New Theories, Same Rules*, N.Y. L.J., Jan. 30, 2008, at 4.

92. In 2007, 57,000 foreclosure complaints were filed in New York, representing a ten percent increase in filings from 2006, and a fifty-five percent increase from 2005. *See* Joel Stashenko, *Pfau Tells Lawmakers*

investment banks seek automatic stays of creditors' actions,[93] and federal courts of general jurisdiction, with exclusive jurisdiction over securities fraud claims, have also experienced dramatic increases in case filings.

In the state court proceedings, attorneys for mortgagors are taking the offensive and asserting traditional causes of action against lenders—including civil fraud, unfair debt collection practices, and predatory lending claims—but they are also advancing new theories for recovery of damages from mortgagees and to preclude foreclosure.[94] Because they played more than their usual role as evaluators of creditworthiness, credit rating agencies may also face suit as participants in fraudulent schemes.[95] Both the SEC and the Attorney General of New York have already opened investigations into the

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Courts Not Equipped to Handle Proposed Foreclosure Conferences, N.Y. L.J., May 13, 2008, at 1. In the first three months of 2008, filings were fourteen percent over the first three months of 2007. *Id. See also* N.Y. CT. R. 212.12-a (requiring pre-foreclosure court conferences, with the aim to avert foreclosure through modifications, forbearances, and extensions); Ann Pfau, *Residential Mortgage Foreclosure Program, Essay*, N.Y. L.J., Dec. 19, 2008, at 6 (discussing the new Court Rule in New York State and the programs set up by legal services entities to assist homeowners in the process).

93. A recent article estimated that of the $633 billion of Lehman Brothers' debt, $1.6 billion is the projected amount of fees that lawyers, accountants, and other professionals may earn from working on that bankruptcy. Jill Schachner Chanen, *Lehman by the Numbers*, 95 A.B.A. J. 12, 12 (2009). Of that $1.6 billion, $53 million is projected as fees to counsel for the Creditors' Committee and $209 million for the firm's bankruptcy counsel. *Id.*

94. *See* Steven Seidenberg, *Homing In On Foreclosure: Lawyers Are Finding Aggressive Defenses Against Foreclosure Actions. And Courts Are Listening As Never Before*, 94 A.B.A. J. 54, 54 (2008); White & Hirschhorn, *supra* note 21, at 20. Another theory that may be available to buyers of MBS is to argue that they are third-party beneficiaries of these contracts between the borrowers and lenders, and that therefore, can assert claims against those in this nexus for fraud or misrepresentation in the sale of mortgages in the pool, for failure to enforce the underlying mortgages and for failure to make good on insurance and guarantees. *See Seidenberg*, *supra*, at 54; White & Hirschhorn, *supra* note 21, at 20.

95. *See* McGuinness & Brewer, *supra* note 88, at S6. But, will credit ratings agencies succumb to liability in suits by purchasers of the securities they rated? Traditionally they have fared well because of several theoretical barriers, including those that find that the ratings were merely opinions and therefore protected by the First Amendment, as well as those that find no showing of malice, no reliance, no causation, and thus no common questions of law or fact to enable class certification. *See id.*

underwritings and sales of mortgage-backed securities.[96]

Title insurers now face tremendous risks because of the way in which securitization of mortgages is done. Often no formal assignment of the mortgage is made; that is, entities involved in originating and securitizing loans frequently do not comply with the formalities of assigning the mortgage notes and physically transferring them.[97] This means that a title search will not necessarily reveal who owns the mortgage. One significant consequence of this system is that, at the time of a foreclosure action, the foreclosing entity may not be the current right holder.[98]

IV. Call For Ethics and Reforms

The failure of finance will affect ideology. Perhaps, because the crisis in the markets was unprecedented and its origins so novel, the Federal Government's responses could not be anything other than piecemeal, ad hoc, and a form of trial and error. The crisis hit worldwide, as financial systems across the globe are highly interconnected.[99]

American economist, Irving Fisher, remarked nearly a century ago that once started, deflation tends to feed on itself.[100] As incomes fall in a depressed economy, the burden of debt becomes more onerous, and the prospect of further decline produces a demoralizing effect and discourages investment.

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96. *See SEC Probes Subprime*, NAT'L MORTGAGE NEWS, Sept. 22, 2008, at 1.

97. *See, e.g.*, In re Foreclosure Cases, Nos. 1:07CV2282, 07CV2532, 07CV2560, 07CV2602, 07CV2631, 07CV2638, 07CV2681, 07CV2695, 07CV2920, 07CV2930, 07CV2949, 07CV2950, 07CV3000, 07CV3029, 2007 WL 3232430, at *3 (N.D. Ohio Oct. 31, 2007). *See also* LaSalle Bank Nat'l Ass'n v. Lamy, 824 N.Y.S.2d 769 (Sup. Ct. 2006) (mortgages that were in the process of foreclosure had been assigned by Mortgage Electronic Registration Systems, Inc. ("MERS"), but notes had not yet been transferred). For a discussion of MERS, see *MERSCORP, Inc. v. Romaine*, 8 N.Y.3d 90 (2006).

98. *See generally* Seidenberg, *supra* note 94 (reporting on the dismissal of fourteen separate foreclosure complaints because the plaintiffs failed to produce documentation confirming that they were the holders and owners of the mortgages on which they were seeking to foreclose). *See also, e.g.*, *In re Foreclosure Cases*, 2007 WL 3232430, at *3.

99. *See* POLICY STATEMENT, *supra* note 67, at 8-9, 15-16.

100. *See* Paul Krugman, *On the Edge*, N.Y. TIMES, Feb. 6, 2009, at A27.

The result is a spiral to the death.[101] The same can be said for other forms of financing instability; the cycle is self-propagating and self-fulfilling.[102]

The Government's first response to the looming financial crisis was to provide liquidity to markets generally. It made money available for short-term loans and it lowered the target rate for federal funds.[103] But in early 2008, when the evidence started mounting that many firms were overextended, a panic set in.[104]

In September 2008, the Federal Government placed Fannie Mae and Freddie Mac under conservatorship as a preemptive measure against collapse due to the institutions' mountains of debt.[105] When the monetary policy measures proved ineffective, the Secretary of the Treasury thought the only way to get the economy moving again was by removing the troubled assets from the banks' books.[106] This plan was

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101. *See id.*

102. KINDLEBERGER & ALIBER, *supra* note 55, at 21-29.

103. POLICY STATEMENT, *supra* note 67, at 5. *See also* DAY, YI TONG & MALMQUIST, Nov. 2008, *supra* note 21, at 5 (noting that "the Federal Reserve lowered the target rate for federal funds on December 16[, 2008] to a range between zero and 25 [base points]"). *See also generally* FED. RESERVE BD., ANNUAL REPORT 2008: MONETARY POLICY AND THE ECONOMIC OUTLOOK, www.federalreserve.gov/boarddocs/RptCongress/annual08/sec1/c1.htm.

104. The case of Bear Stearns stands out. In March 2008, while the firm was solvent, it was highly leveraged (and heavily dependent upon overnight repossessions). Mizen, *supra* note 17, at 549. Creditors were unwilling to allow the firm to hobble along until it eventually collapsed under its own weight. *Id.* Previously, two hedge funds that were advised by Bear and were created to invest subprime mortgage-related assets had collapsed. *Id.* at 533. Because of Bear's heavy exposure to mortgage-related assets, its creditors became jittery, despite the fact that the firm was adequately capitalized under SEC rules and its secured debt was rated AAA by Standard & Poor's. *Id.* at 559. The Federal Reserve intervened to broker a deal to rescue Bear Stearns. *Id.* at 549, 557-58.

105. On September 7, 2008, the Director of the Federal Housing Finance Agency announced the Federal takeover; both entities were placed into conservatorship run by the Federal Housing Finance Agency in order to ensure their financial soundness. *See* Statement of James B. Lockhart, Director, Federal Housing and Finance Agency (Sept. 7, 2008), *available at* http://www.treasury.gov/press/releases/reports/fhfa_statement_090708hp1128.pdf.

106. *See* Troubled Assets Relief Program ("TARP"), Pub. L. No. 110-343, 122 Stat. 3768 (2008) (to be codified at 12 U.S.C. §§ 5211-41). Under the Program, $700 billion was appropriated for, among other things, the purchase of worthless assets from firms. *Id.*

designed to address the phenomenon of "counterparty risk," that is, the situation that occurs when the winners'[107] extra spending may not offset the losers'[108] retrenchment.[109] And the losers may not be able to afford to pay out, because they do not have the money—they are insolvent—or because they cannot easily raise the money—they are illiquid.[110] By effectively recapitalizing banks, the Treasury would minimize the appearance of counterparty risk.[111] In later efforts, the Treasury opted to purchase equity stakes in the distressed financial institutions.[112]

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107. I.e., those whose investments pay off.

108. I.e., those whose investments sink.

109. *See Strategy: Signs of an Early American Recovery*, FUND STRATEGY, Nov. 24, 2008, at 16 (2008) (London).

110. *See id.* In fact, the bulk of the cash infusions were used as recapitalizations. *See generally* U.S. Office of the Special Inspector General for the Troubled Asset Relief Program, www.sigtarp.gov/reports.shtml (last visited Oct. 31, 2009) (reporting on the use of TARP funds). Without it, it was thought that many banks would have become insolvent. Still, the underlying problems remain—the toxic assets are still on the books and banks are still not lending. *See* David Stout, *Better Answers Sought on Banks' Use of Aid*, N.Y. TIMES, Jan. 31, 2009, at B8 (reporting on how the original strategy proved ineffective as banks hoarded their new capital instead of making loans); *Regulator Says Bailout Fund is Misleading the Public*, N.Y. TIMES, Feb. 6, 2009, at B2 (reporting that testimony before a Senate oversight committee claimed that Secretary of the Treasury, Henry M. Paulson, Jr., had misled Congress by not doing what he said he would do; that the bailout "was opaque at best"; that of the $254 billion invested into financial institutions at the time, only $176 million in value had been received; and that the shortfall was not accounted for or explained). American International Group ("AIG"), once the world's largest insurer, was bailed out by the Federal Government when it became clear that it would not be able to honor its vast one-way bets on financial stability. James Bullard, Christopher J. Neely & David C. Wheelock, *Systemic Risk and the Financial Crisis: A Primer*, 91 FED. RESERVE BANK OF ST. LOUIS REV. (PART I) 403, 412 (2009). If AIG had failed, the banks on the other side would have been in trouble. Although the market netted to zero, it was poised for disaster. *Id.*

111. *See* Steven L. Schwarcz, Keynote Address, *Understanding the Subprime Financial Crisis*, 60 S.C. L. REV. 549, 556 (2009). However, the significant early problem with this program was valuing these "troubled assets." *Id.* at 557-58. In order to maintain the appearance, the Federal Government would have to pay market value—but how to value assets that have no reliable market value is not clear. *Cf. id.* at 558 (positing that the Government must pay more than the fair market value of the troubled assets). This problem is further exacerbated by the lack of transparency in the packaging and pooling of the underlying assets. *See id.* at 557-58.

112. *See* Tarp Capital Purchase Program, 73 Fed. Reg. 62205-01 (Oct. 30, 2008) (codified at 31 C.F.R. pt. 30). Under the Program, the Treasury Department will aim to fund the banking system by purchasing stock in

"The case for doing something to prevent the next financial market meltdown is compelling. What that 'something' should be, though, is not."[113] The Federal Reserve and the Treasury Department sensibly acted quickly to shore up confidence in markets and to head off losses. "However, history suggests

institutions. $250 billion has been allocated for this program. *See also* Press Release, U.S. Dep't of the Treasury, Treasury Announces TARP Capital Purchase Program Description (Oct. 14, 2008), *available at* www.treas.gov/press/releases/hp1207.htm. On November 25, 2008, the Federal Reserve unveiled two plans, totaling $800 billion, aimed at boosting spending and limiting damage from the weakening economy. The first, titled the Term Asset-Backed Securities Loan Facility ("TALF"), created a $200 billion lending facility to spur purchases of securities backed by consumer and small-business loans. *See* FED. RESERVE, TERM ASSET-BACKED SECURITIES LOAN FACILITY (TALF) TERMS AND CONDITIONS 1 (2008), *available at* http://www.federalreserve.gov/newsevents/press/monetary/monetary20081125a1.pdf. The program makes loans to holders of certain asset-backed securities collateralized by student loans, auto loans, credit card loans, and loans guaranteed by the Small Business Administration. *Id.* In the second program, the Federal Reserve will buy up to $100 billion in direct debt issued by Government-Sponsored Enterprises ("GSEs") and makes a similar pledge to buy up to $500 billion in mortgage-backed debt issued by the GSEs. *See* Press Release, Fed. Reserve Sys., Federal Reserve Announces it Will Initiate a Program to Purchase the Direct Obligations of Housing-Related Government-Sponsored Enterprises (Nov. 25, 2008), *available at* www.federalreserve.gov/newsevents/press/monetary/200811256.htm. The Federal Reserve put into place several protections against losses, including limiting the lending facility to securities that hold the highest investment rating from two or more nationally recognized credit rating agencies. *See* FED. RESERVE, *supra*, at 1-3. Also, investors must provide the Reserve with collateral worth more than loans they receive from TALF, *id.* at 2-3, and must set up special purpose vehicles that will be used to hold or sell securities if borrowers default on the underlying credit exposures, *see id.* at 3. On December 3, 2008, the Federal Reserve reported to Congress that it had purchased $40 billion of stock in American International Group under the Capital Purchase Program. *See* FED. RESERVE, PERIODIC REPORT PURSUANT TO SECTION 129(B) OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008: UPDATE ON OUTSTANDING LENDING FACILITIES AUTHORIZED BY THE BOARD UNDER SECTION 13(3) OF THE FEDERAL RESERVE ACT 7 (2008), www.federalreserve.gov/monetarypolicy/files/129periodicupdate.pdf (last visited Nov. 3, 2009). As of December 2008, the Reserve had signed agreements with 84 financial institutions, under the CPP, committing $165 billion. *See* Capital Purchase Program, Transaction Report (2008), www.financialstability.gov/docs/CPP/CPPTransaction%20ReportDec%209.pdf (last visited Nov. 3, 2009) (listing the institutions purchased under the program and the costs paid for each as of December 9, 2008). Nine of the largest banks in the nation received the first $125 billion. *See id.* Citigroup received $25 billion. *Id.*

113. Robert Hahn & Peter Passell, *The Rush to Re-Regulate*, ECONOMISTS' VOICE, July 2008, at 3, *available at* http://www.bepress.com/ev/vol5/iss3/art5/ (follow "Download").

that tackling an ambitious agenda for reform in the midst of a financial crisis is an invitation to bad regulation—regulation whose costs exceed the benefits; regulation that serves the interests of politically connected insiders rather than those of the public."[114]

Now that there has been much time and much consideration of the flaws and interrelatedness of the markets and the effects of the practices by industry participants, regulatory and industry reforms can be thoughtfully conceived. The focus should be on systemic damage. These reforms must have at least three aims: first, to preserve homeownership; second, to protect the integrity of the markets; and third, to avoid the moral hazard.

A. *Preserving Homeownership*

Inasmuch as the financial crisis began with falling home prices and fears sparked by rampant mortgage defaults, it seems that the first step out of this crisis is to stem the rate of foreclosures. Remaining TARP funds[115] should be used to buy up assets and then to refinance the mortgages underlying those assets.[116]

Many different kinds of interventions have been proposed and implemented. The proposals have included: requiring refinancing of loans underlying the mortgages held by the GSEs;[117] permitting states to refinance loans at risk of

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114. *Id.*

115. *See supra* note 106.

116. However, because of the multilayer and split-up nature of securitized mortgages, modification of individual loans may be difficult even for creditors so inclined.

117. *See, e.g.*, Press Release, U.S. Dep't of the Treasury, Treasury Interim Assistant Secretary for Financial Stability Neel Kashkari Remarks on GSE, HOPE NOW Streamlined Loan Modification Program (Nov. 11, 2008), *available at* http://www.treas.gov/press/releases/hp1264.htm; United States Department of Housing and Urban Development ("USDHUD"), Fact Sheet: Hope for Homeowners to Provide Additional Mortgage Assistance to Struggling Homeowners, http://www.hud.gov/hopeforhomeowners/pressfactsheet.cfm (last visited Aug. 14, 2009). Under the Hope for Homeowners program, the Federal Housing Administration insures troubled loans if the lender first agrees to write off a portion of the principal. USDHUD, *supra*. Eligible loans would include those with loan-to-value ratios up to 96.5 percent for borrowers whose refinancing mortgage payments represent no more than 31 percent of their monthly gross

foreclosure through issuance of federal tax-exempt mortgage revenue bonds;[118] and creating a new federal corporation to purchase distressed mortgages from investors and convert them to 30-year fixed-rate mortgages.[119]

There have also been proposals for moratoria on foreclosures. In early 2009, the legislatures of several states introduced bills that would have imposed them.[120] Additionally, similar legislation was also introduced in Congress.[121] There is much debate about the wisdom and

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income, and whose total debt does not exceed 43 percent of their income. *Id.* Lenders may also extend mortgage terms to 40 years in order to reduce monthly payments. *Id.* Another proposal would have the Federal Government share the cost of reducing a borrower's monthly payment. *Id.* A lender or servicer would initiate a loan modification and agree to reduce payments to perhaps 38 percent of a borrower's income; the Government would then step in and subsidize a further reduction, to perhaps 31 percent. *Id.* Previously, the FDIC announced a plan to refinance loans issued by failed banks that it had taken over. *See* FDIC, Loan Modification Program for Distressed Indymac Mortgage Loans, www.fdic.gov/consumers/loans/modification/indymac.html (last visited Nov. 1, 2009). On March 4, 2009, Fannie Mae announced the Obama Administration's plan to help preserve home ownership, "Making Home Affordable," which will help refinance mortgages held or guaranteed by FannieMae. *See* Fannie Mae, Making Home Affordable, https://www.efanniemae.com/sf/mha/index.jsp (last visited Aug. 14, 2009).

118. *See* Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, § 1338, 122 Stat. 2654, 2712-23 (to be codified at 12 U.S.C. § 4568).

119. This last proposal would mimic the Home Owners' Loan Corporation ("HOLC"), which was established to purchase delinquent home mortgages during the Great Depression. *See* Act of June 13, 1933, ch. 64, § 1, 48 Stat. 128 (codified as amended at 12 U.S.C. §§ 1461-68 (2006)). The HOLC is viewed as having been highly successful, and it achieved this success at low taxpayer cost—there was only an initial $200 million capitalization, and this was eventually repaid. David C. Wheelock, *The Federal Response to Home Mortgage Distress: Lessons From the Great Depression*, 90 FED. RESERVE BANK OF ST. LOUIS REV. (PART I) 133, 144 (2008). HOLC purchased about a million loans from their originators and then refinanced them as long-term, fixed-rate, fully-amortized loans that were payable in monthly installments. *Id.* at 146. Although it purchased only delinquent loans, it ended up foreclosing on fewer than twenty percent of the refinanced loans. *Id.*

120. *See, e.g.*, H. 1510, 186th Gen. Ct. (Mass. 2009); H. 2233, 86th Leg. Sess., 1st Reg. Sess. (Minn. 2009); A. 8236A, 232nd Leg. Sess. (N.Y. 2009); S. 4109B, 232nd Leg. Sess. (N.Y. 2009). *See also* David C. Wheelock, *Changing the Rules: State Mortgage Foreclosure Moratoria During the Great Depression*, 90 FED. RESERVE BANK OF ST. LOUIS REV. 569, 570 (2008).

121. *See* S. 2734, 110th Cong. (2d Sess. 2008). *See also* MURPHY, *supra* note 23, at 1; Wheelock, *supra* note 120, at 570.

efficacy of moratoria.[122] Opponents argue that foreclosure moratoria make loans costlier—with higher interest rates in order to compensate for the added risks associated with an inability to foreclose—and more difficult to obtain—due to lenders' restricting the supply of their loans.[123] At the same time, lenders benefit in the short run from moratoria as they allow time for the development of programs to refinance delinquent mortgages. Without moratoria, high foreclosure rates reduce property values, prompting still more foreclosures, leading to a downward spiral in property values, and thereby hurting lenders and contributing to further reduction in mortgage failures.[124]

Congress should amend the bankruptcy code and give bankruptcy judges the power to modify the mortgages of debtors in bankruptcy.[125]

B. *Protecting the Integrity of the Markets*

Banks are the essential engines of the economy. As the

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122. Many lenders in the last year have imposed voluntary moratoria on foreclosures. During the Great Depression, by one estimate, approximately one-half of all urban home mortgages were delinquent, as of the beginning of 1934. *See* Wheelock, *supra* note 120, at 569. State and local governments responded by changing state laws governing foreclosure. *Id.* at 570. These measures included enhancements of borrowers' redemption rights and limiting deficiency judgments. *Id.*

123. *Id.* at 580. David Wheelock, Assistant Vice President and Economist for the Federal Reserve Bank of St. Louis, suggests that the states ignored this reality, believing that unrestricted foreclosures would result in many people becoming homeless simultaneously. *See id.* at 580. He further suggests that these moratoria were also expedients to buy time while the economy recovered. *See id.* at 580.

124. *Id.* at 581.

125. The current policy of not permitting a bankruptcy workout on a mortgage secured by a primary residence is "intended to encourage the flow of capital into the home lending market." Adam J. Levitin & Joshua Goodman, *The Effect of Bankruptcy Strip-Down on Mortgage Markets* 4 (Georgetown Univ. Law Ctr., Working Paper No. 1087816, 2008) (quoting Nobelman v. Am. Sav. Bank, 508 U.S. 324, 332 (1993) (Stevens, J., concurring)), *available at* http://ssrn.com/abstract=1087816 (follow "Download"). That is, by providing greater security to investors with the recourse of foreclosure, it is possible for lenders to offer lower interest rates on primary residences, thereby encouraging the expansion of homeownership among borrowers who would otherwise be unable to afford payments based on higher interest rates. *Id.*

recent measures of the health of economy have revealed in the last two years—such as through dismal reports on consumer spending, unemployment, and exports—when banks became dysfunctional, economic activity stopped. Wall Street is still reeling and still contracting. Although some assets, such as good quality corporate debt, seem cheap, investors are still skittish. Instead, what we are experiencing is what Keynes called the "paradox of thrift,"[126] in which household savings grow and the financial services industry sheds its debt, thereby leading to a further reduction in spending—which means no earnings for sellers of services and products, and in turn, that people lose jobs. While the Federal Reserve seems committed to rescuing big investment banks "too complex to fail,"[127] correction of the turmoil in the markets calls for policies that are well-orchestrated and coherent, so as to guide us forward, and to avoid waste and future disruptions. One economist has remarked that, to date, "the government had done it with an extreme degree of inconsistency. You almost have to be trying to do things in an incoherent and inconsistent way to end up with the huge range of ways they have come up with to address these problems."[128]

But is a complete rewriting of financial regulation in order, or should finance be free to innovate? During the Great Depression, America tried to tame finance's most dangerous traits through heavy regulation aimed at safety.[129] However clear-sighted such a move seems now, it should not be followed at this time without taking advantage of hindsight—that is, a look at the circumstances of the Great Depression in comparison to what is occurring today. "In 1933, the United States economy had shrunk by one-third in real terms since 1929. Industrial production had fallen by 40 percent. Unemployment had soared to 25 percent, from 3 percent in

126. *See generally* JOHN MAYNARD KEYNES, THE GENERAL THEORY OF EMPLOYMENT, INTEREST AND MONEY (1936).

127. Hahn & Passell, *supra* note 113, at 1.

128. Television Interview by Fox Business Network with David Swenson, Yale Univ. Chief Inv. Officer (Jan. 6, 2009), *available at* http://www.foxbusiness.com/story/markets/business-leaders/yale-investment-chief-sticking-tried-tested/ (follow the first video image).

129. *See Fixing Finance*, ECONOMIST (SPECIAL REPORT) (London), Jan. 24, 2009, at 20, 21.

1929."[130] In addition to the Reconstruction Finance Corporation ("RFC") buying up stock in 6,000 banks—at a cost of $1.3 billion, which is about $200 billion in today's dollars—the Roosevelt-era Congress also put into place a whole slate of remedial measures, such as bank deposit insurance and disclosure requirements for securities issuers.[131] Other measures were also enacted that aimed to raise prices by reducing or controlling output.[132] Congress did this through initiatives such as the National Industrial Recovery Act,[133] which had been championed by big businesses. The effects of these measures and their restraint and retardation of commerce were long-standing.[134]

If we agree that the fundamentals of the lending and banking sectors are sound, that the crisis resulted from a confluence of fortuitous or exogenous circumstances (i.e., a huge availability of liquidity by foreign investors and sovereign wealth funds, as well as by opportunistic conduct from a small number of market participants), then a lightly regulated finance industry will be in our best interest.

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130. Steve Lohr, *Something to Fear, After All*, N.Y. TIMES, Jan. 27, 2009, at B1. The day after his inauguration on March 4, 1933, President Roosevelt "declared a national bank holiday, and set the Federal Reserve and the Treasury to work on a phased program to sort good banks from bad ones, provide financing and restore confidence in the banking system." *Id.* Measures were also carried out by the Reconstruction Finance Corporation ("RFC"), established in 1932. *Id.* "The agency made loans to troubled banks and seized and sold off distressed assets at others. After government inspections, many small banks never reopened, with more than 4,000 closed in 1933." *Id.* Historians have speculated that had the government intervened sooner, recovery would have been quicker. *Id.* As it stood, the economy did not fully revive until a decade after the crash, in great measure as a consequence of the military escalation for World War II. *Id.* Most historians still recognize the need for massive government spending—"[b]y 1942, total government spending as a share of the economy rose to 52 percent, and peaked at nearly 70 percent in 1944, when unemployment fell to 1 percent." *Id.*

131. *Id.*

132. *Id.*

133. National Industrial Recovery Act of June 16, 1933, ch. 90, § 1, 48 Stat. 195-211 (repealed 1935). The Act was later declared unconstitutional as a violation of the Commerce Clause. *See* A.L.A. Schechter Poultry Corp. v. United States, 295 U.S. 495 (1935).

134. Among other things, the Act exempted industries from antitrust prosecution if they agreed to enter into collective bargaining agreements with their workers, which significantly raised wages. As a consequence, the price of goods and services increased at the same time that wages became inflated.

To address the immediate crisis and to provide confidence in the future, we should resist calls to close the Federal Reserve's "discount window"; the federal regulations and programs are a way to direct assistance to needy entities without changing monetary policy, as well as a way to empower the Reserve to move quickly toward a measure of price stability. The Federal Reserve should, though, remain the lender of last resort, and when it lends it should do so on a "penalty rate, i.e., on good (but not perfect) collateral."[135] Public money should come with strings attached; if a rescue of the next Bear Stearns is to occur, the beneficiaries of the rescue should pay. Congress and the Treasury Department are only now coming to this stance after learning of the billions of dollars paid in bonuses to employees by banks who received bailout monies[136] and of Citicorp's plan to purchase a new corporate jet, arguably enabled by the availability of bailout monies.[137] The proposed limits on the compensation levels of executives of companies who are recipients of taxpayer funds should be implemented in a meaningful matter, with few ways for circumvention. The remainder of the TARP funds should not be used to bail out the banks, since the facts have shown that the interests of the banks do not necessarily coincide with those of the nation—they did nothing to make credit available, and instead used the public bailout funds to consolidate their balance sheets and survive longer.[138]

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135. WALTER BAGEHOT, LOMBARD STREET: A DESCRIPTION OF THE MONEY MARKET 197 (Hartley Withers, ed., E.P. Dutton & Co. 1920) (1873).

136. *See supra* note 65.

137. Joe Nocera, *It's Not the Bonus Money. It's the Principle*, N.Y. TIMES, Jan. 31, 2009, at B1.

138. In the second governmental bailout of Citigroup, "taxpayers poured $60 billion . . . , increasing the value of Citigroup financial claims by only $44 billion, with a net loss of $16 billion." Luigi Zingales, *Yes We Can, Secretary Geithner*, ECONOMISTS' VOICE, Feb. 2009, at 2, *available at* http://www.bepress.com/ev/vol6/iss2/art3/ (follow "Download"). This meant that "each dollar donated to financial investors cost $1.36 to taxpayers, with no additional benefit." *Id.* Luigi Zingales, Professor of Entrepreneurship and Finance at the University of Chicago Booth School of Business, believes this result was "easily predictable," since it was hardly to be expected that a bank, hobbling and newly rescued from disaster, would have the courage to thrust itself right back into the volatile economy. *Id.* Instead, Professor Zingales suggests that the sensible thing for the Government to have done was to have "taken over these banks and directed the flow of credit, or [to] have poured in an amount of capital so large that even scared bankers would consider

Congress should reassess the role of GSEs in the financial markets and establish risk controls.[139] Together, Fannie Mae and Freddie Mac owned or guaranteed more than $4 trillion of home mortgages, of which nearly half were outstanding.[140] When mortgagors default, these GSEs are unable to pay their investors their promised returns. To be sure, the secondary market for mortgages is vital to achieving the national goal of homeownership, but the risk of losses from these purchases should be spread more widely in order to blunt the impact.

Standards or guidelines should be adopted for credit ratings agencies.[141] Some suggest that government regulations are not necessary because the market will correct the problem of ratings itself, as "once-burned investors treat ratings pronouncements more skeptically."[142] Indeed, regulation of credit rating agencies may do more harm than good by undermining investors' incentives to do their homework. Yet transparency should be emphasized. Much of the losses occurring in the housing finance markets can be attributed to a lack of information on the part of investors and mortgagors, either because the information was not offered or provided, or because it was too difficult to obtain. While the recent experiences by investors and mortgagors should prompt more

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restarting the lending process." *Id.* at 3.

139. There has been a debate about whether an implicit guarantee by the Federal Government of the GSEs' debts encouraged, or at least facilitated, excessive risk-taking. *See generally* David Reiss, *The Federal Government's Implied Guarantee of Fannie Mae and Freddie Mac's Obligations: Uncle Sam Will Pick Up the Tab*, 46 GA. L. REV. 1019 (2008). If the current state of the GSEs' balance sheets does not settle the issue, then it is doubtful that anything will. Indeed, that guarantee has become explicit.

140. *See A Primer on the Secondary Mortgage Market*, 2008 OFFICE FED. HOUS. ENTER. OVERSIGHT, MORTGAGE MARKET NOTE pt. 3, at 2, *available at* http://www.fhfa.gov/webfiles/1242/MMNOTE083.pdf.

141. *See generally* POLICY STATEMENT, *supra* note 67. On December 3, 2008, the Securities and Exchange Commission voted to adopt rules designed to bolster oversight of credit rating agencies. *See* Press Release, U.S. Sec. & Exch. Comm'n, SEC Approves Measures to Strengthen Oversight of Credit Rating Agencies (Dec. 3, 2008), *available at* http://www.sec.gov/news/press/2008/2008-284.htm. The new rules aimed to improve disclosure, reporting, and recordkeeping practices of the nationally recognized statistical rating organizations in order to reduce conflicts of interest at these entities and to promote competition within the industry. *Id.* In particular, the new rules would require disclosure of the ratings history for all issuer-paid ratings. *Id.*

142. Hahn & Passel, *supra* note 113, at 3.

vigilance, transparency by the lenders and agents will achieve important efficiency goals in financial markets, particularly considering that the information needed to make wise decisions changes rapidly in our complex markets.

Lenders should be required to adjust their capital cushions to reflect their risks in falling markets. The task of measuring such risks in a world in which every major lender depends on every other major lender to honor financial contracts is truly daunting. One must wonder whether more regulation here would drive lenders from the high-risk credit on which cutting-edge businesses depend.

C. *Avoiding the Moral Hazard*

Was it just shortsightedness that contributed to the current market failure? Was it willfulness—or just greed? Was it the larceny in the human heart? Who is to blame for all the mispricing and poor results? Individual responsibility is not absolute. Behavioral economists have demonstrated that humans are powerfully and unwittingly influenced and co-opted by prevailing ideas and assumptions.[143] We are unable to resist the enticement of something for free—such as mortgage loans that are provided without documentation of income, and which require no down-payments.

Shortsightedness can be responded to in some measure by requiring more stringent underwriting standards by lenders, greater disclosure to investors, increased transparency by ratings agencies, and stricter and more prudent accounting by the issuers. But how to respond to willfulness and greed? Removing the opportunities for acting out on temptations for ill-gotten gains, such as by mandating capital requirements and banning the use of off-balance sheet vehicles, and adherence to Basel Standards[144] would be the first thoughts.

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143. *See generally* John Gowdy & Irmi Seidl, *Economic Man and Selfish Genes: The Implications of Group Selection For Economic Valuation and Policy*, 33 J. SOCIO-ECON. 343 (2004).

144. The Basel Committee is a consortium of international banking representatives who analyze and provide recommendations and guidelines on a wide variety of financial issues. *See* Bank for Int'l Settlements, History of the Basel Committee and Its Membership, http://www.bis.org/bcbs/history.htm (last visited Aug. 16, 2009).

But, if we operate on the premise that evil lurks within us all, then sterner measures may be in order, such as stiff civil and criminal penalties for violating accounting standards, for nondisclosure, and for misrepresentations.

In the meantime, how can newly-rescued borrowers be convinced to be more watchful in the future? How can others be made to heed the rashness of those who faced ruin before? How can the experiences of Long-Term Capital Management[145] become instructive so as to prompt an attitude of prudence, as opposed to one that is cavalier, on the belief that their unsound loans would be made good by the Federal Government? Perhaps the key to avoiding or minimizing the moral hazard is to restrict intervention to truly exceptional circumstances. Assistance should perhaps be limited to aiding those at risk of losing their homes, but it should not enable overreaching lenders to avoid the loss of their vacation homes.[146] But separating out the bad from the stupid is no easy task. FDIC Chairman Sheila Bair believes that a "complex interplay of risky behavior by lenders, borrowers, and investors led to the current financial storm."[147] In fact, she stated that "the lending practices that are causing problems today were driven by

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145. In 1998, the hedge fund Long-Term Capital Management was on the brink of collapse, standing to lose $100 billion. *See* FERGUSON, *supra* note 9, at 323-27. The Fund had been managed by finance quants who had made many unsound, esoteric bets, including investments in interest-rate derivatives. *Id.* at 323-25. Russia's inability to pay its debts sent global markets into turmoil and put the fund, which was saddled with high-leverage and off-balance sheet obligations, near collapse. *See id.* at 328. Because the fund owed large sums to banks and other financial institutions, its collapse could have meant ruin for these investors. *See id.* at 327. The Federal Reserve thus intervened by putting together a consortium of companies to buy it out and cover its debts. *Id.* While all the shareholders of the fund were wiped out, the creditors were protected. Ten years later, Lehman Brothers was allowed to fail by the Federal Reserve. *See supra* note 41 and accompanying text. Its debts have been estimated to exceed $600 billion. *See supra* note 93.

146. Richard S. Fuld, Jr., Chairman and Chief Executive Officer of Lehman Brothers, who tried to blame everyone else for the market collapse, recently sold his $13 million mansion in Florida to his wife for $10.00. Clyde Haberman, *Imparting Some Shame to Those Who Trade in Greed*, N.Y. TIMES, Jan. 27, 2009, at A25.

147. Sheila Bair, Chairman, FDIC, Remarks Before the Consumer Federation of America (Dec. 4, 2008), *available at* http://www.fdic.gov/news/news/speeches/archives/2008/chairman/spdec0408_2.html.

desire for market share and revenue growth . . . pure and simple."[148]

V. Conclusion

The fault lies not in securitization, but in ourselves—in our abuses, carelessness, and cupidity. While securitization achieves definite efficient goals—such as dividing up and spreading risk suitable to investors' varying objectives and levels of risk adversity, and by reducing the equity capital needed by intermediaries to absorb the risk of the assets being intermediated—it remains to consider whether the risks created by a process that operates without limits and transparency are greater than the risks it purports to allocate in the first place.

148. *Id.*