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The Subprime Crisis—Some Thoughts on a "Sustainable" and "Organic" Regulatory System

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"Credit is suspicion asleep"

-William Gladstone[2]

I. INTRODUCTION

The Nation is now in the midst of one of the greatest financial crises in its history. Much of the blame for this condition is being placed on the bursting of the residential real estate bubble, which was fueled in large part by the reckless expansion of subprime mortgage lending. Those mortgages began defaulting in droves as the Federal Reserve Board drove up interest rates, causing massive losses at Bear Stearns, Lehman Brothers, Morgan Stanley, Citigroup, Wachovia, Washington Mutual, Countrywide Financial Group, American International Group and Merrill Lynch, to name a few. Those losses were shocking but paled in comparison to the failures of Lehman Brothers and Bear Stearns and the placing of Freddie Mac and Fannie Mae into conservatorship. Massive bailout packages for the financial service firms failed to restart lending, the country slipped into recession and unemployment soared. The subprime crisis had other ripple effects. The Dow Jones Industrial average was down 47 percent on February 19, 2009 from the high of 14,087 that was reached on October 1, 2007.[3] This devas-

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1 Professor of Law, Florida International University College of Law, Miami, Florida.

2 *Quoted in* AMITY SHLAES, THE FORGOTTEN MAN: A NEW HISTORY OF THE GREAT DEPRESSION 336 (2007).

3 E.S. Browning, *Market Hits New Crisis Low*, WALL ST. J., Feb. 20, 2009, at A1.

tated retirement savings, college and other endowments, and every other investor in the market.

On the other side of the equation were the subprime borrowers. They too were devastated by the subprime crisis as their adjustable rate mortgages (which had been originally issued at low "teaser" rates) reset at unaffordable levels. Foreclosures became an epidemic in many communities across the country, Florida being one of the worst centers for those sad events. Hispanics were also a particular target for subprime lenders. Hispanic homeownership in the United States grew by 47 percent between 2000 and 2007, compared to an overall homeownership increase of 8 percent.[4] Tellingly, that growth was fueled by the fact that some 47 percent of mortgage loans to Hispanics were subprime and many of those loans are now being foreclosed.[5] The African-American community has also been hard hit by the subprime crisis. Over one half of mortgage loans to African-Americans in 2006 were subprime, and they too are facing massive foreclosures.[6]

These problems have been blamed on flaws in the financial regulatory structure, and Congress has now begun the process of restructuring that regulation.[7] Hopefully, but not likely, that process will include an objective assessment of how we came to this condition and what changes are needed to deal specifically with those problems. This symposium addresses these issues from both the lenders' and borrowers' perspectives. The *FIU Law Review* is to be commended for attacking these problems from both viewpoints and for attracting such a fine group of scholars to address legal issues raised by this crisis. This Introduction to the symposium will provide a description of the subprime mortgage market, discuss the flaws in the financial system that led to the present crisis, and it will then add a few cautionary suggestions on regulatory reform.

II. SUBPRIME LOANS

There are no uniform standards for classifying a loan as subprime. However, a loan is generally viewed to fall into the subprime category if the borrower falls within one of the three following categories: (1) those with a poor credit history; (2) those with no credit history; and (3) borrowers who

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4 Susan Schmidt & Maurice Tamman, *Housing Push for Hispanics Spawns Wave of Foreclosures*, WALL ST. J., Jan. 5, 2009, at A1.

5 Algernon Austin, *Subprime Mortgages Are Nearly Double for Hispanics and African Americans,* ECONOMIC POLICY INSTITUTE (June 11, 2008), *available at* http://www.epi.org/economic_snapshots/entry/webfeatures_snapshots_20080611/.

6 Gail Russell Chaddock, *A Housing Rescue Nears - But for Whom?,* THE CHRISTIAN SCIENCE MONITOR, July 22, 2008, at §USA1.

7 Some pretty dramatic proposals are already on the table. *See* The Department of the Treasury, *Blueprint for a Modernized Financial Regulatory Structure* (Mar. 2008) (proposing a massive restructuring of financial regulation into an "objectives" based regulatory system).

have existing credit but are over extended.[8] Factors considered in classifying a loan as subprime include credit history, household debt-to-income ratio, and combined loan-to-value ratio for home equity loans and other mortgage debt.[9] FICO credit scores are also used to identify subprime borrowers.[10]

Subprime lending is risky lending because of a high likelihood of default. By definition, such borrowers are poor credit risks, necessarily resulting in higher interest rates and fees to cover those risks. In contrast to the subprime borrower classification, "prime" (A-Credit) borrowers have strong credit scores, allowing them to obtain the most competitive interest rates and mortgage terms.

Historically, the subprime market was avoided by large commercial banks because of the default risk. As a result, subprime borrowers, until recent years, were serviced by non-conventional lenders and were often the targets of predatory lending practices.[11] Government policy sought to change that market by encouraging, even forcing, conventional lenders to make subprime mortgage loans to the poor. The Home Mortgage Disclosure Act of 1975 ("HMDA"),[12] for example, required banking institutions in metropolitan areas to disclose their mortgage loans by classification and geographic location. This was an effort to expose the practice of "redlining," in which banks concentrated their lending in wealthier neighborhoods. Individuals living in those mostly white neighborhoods generally had

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8 Evan M. Gilreath, Note, *The Entrance of Banks Into Subprime Lending: First Union and the Money Store*, 3 N.C. BANKING INST. 149 (1999).

9 United Companies Lending Corp. v. Sargeant, 20 F. Supp. 2d 192, 196 (D. Mass. 1998). Some subprime borrowers are "house rich" but "cash poor" because of equity built up in their house. *In re* First Alliance Mortgage Co., 471 F.3d 977, 984 (9th Cir. 2006).

10 As one court noted:

> most lenders, use a credit score system called 'FICO.' Named for the system's creator, Fair Isaac Credit Organization, FICO refers to a method for calculating a borrower's credit worthiness. FICO's workings are largely proprietary, but based on the information in a credit bureau's files—e.g., credit card usage and payment history, other revolving loan history, installment loan history, previous bankruptcy, judgments, and liens—FICO returns a score between 300 and 800. The higher the score, the more creditworthy the borrower; the more creditworthy the borrower, the less likely the borrower is to default.
>
> Though 'subprime' has no universal definition, . . . industry custom regarded 660 as the prime-subprime dividing line Further, the US median score is 720. The dispersion is such that only 27% of the population has a score below 650 and 15% of the population scores below 600.

In re Countrywide Financial Corporation Securities Litigation, 588 F. Supp. 2d 1132, 1146-47, 2008 U.S. Dist. LEXIS 102000 (C.D. Cal. 2008) (internal citations omitted). FICO scores are based on reports generated by the three large credit reporting groups: Equifax, Experian and TransUnion. PAUL MUOLO & MATHEW PADILLA, CHAIN OF BLAME, HOW WALL STREET CAUSED THE MORTGAGE AND CREDIT CRISIS 41, n.5 (2008).

11 For a discussion of predatory lending practices see Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending,* 80 TEX. L. REV. 1255 (2002).

12 12 U.S.C. §§ 2801-2811 (2007).

higher incomes and lower default rates than poorer neighborhoods where minorities were often concentrated.[13]

HMDA was followed by the Community Reinvestment Act ("CRA") of 1977.[14] It required banks to meet the credit needs of minorities in their communities.[15] Banking regulators scored banks on their CRA compliance, ranking them from "outstanding" to "substantial non-compliance." That CRA score was required to be considered by banking regulators before approving bank mergers. Activist groups and state regulators pressed banks to make more subprime loans as a condition for the approval of their mergers.[16]

The banks at first resisted the government-inspired effort to force them to make loans to subprime borrowers, especially since such borrowers posed large credit risks. However, in business, a failure to grow is considered death, and the banking model for the last several years has been to merge as the only way of growth. Banks desperate for mergers made pledges of hundreds of billions of dollars of CRA loans to regulators in order to assure approval of their mergers.[17] The government made it easy for the banks to obtain loans to meet these commitments by giving CRA credit for purchases of subprime mortgages originated by non-bank subprime lenders.[18]

Merger-hungry Bank of America announced that it was making a 10-year CRA subprime lending pledge of $750 billion when it merged with

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13 *See generally* National State Bank v. Long, 630 F.2d 981 (3d Cir. 1980) (describing this practice).

14 12 U.S.C. §§2901 *et seq*. (2007).

15 *See generally* Joseph Moore, *Community Reinvestment Act and Its Impact on Bank Mergers*, 1 N.C. BANKING INST. 412 (1997) (describing this legislation and the problems it engendered).

16 LISSA L. BROOME & JERRY W. MARKHAM, REGULATION OF BANKING FINANCIAL SERVICE ACTIVITIES, CASES AND MATERIALS 399 (3d ed. 2008) (hereinafter "Regulation of Banking Financial Service Activities").

17 Community activist groups also demanded funding from banks as a condition for their not protesting their mergers. Since mergers were the principal growth mechanism for large banks, many of them gave into this CRA "extortion." Senator Phil Gramm from Texas inserted a provision in the Gramm-Leach Bliley Act in 1999 that required reports to be filed disclosing any CRA extortion payments (12 U.S.C. §1831y) in the hope that disclosure would embarrass those groups and keep such demands to a minimum. However, that provision did not slow the growth of subprime lending. JERRY W. MARKHAM, A FINANCIAL HISTORY OF MODERN U.S. CORPORATE SCANDALS: FROM ENRON TO REFORM 553 (2005). Interestingly, efforts were made to extend the CRA to mutual funds during the Clinton administration. MATTHEW P. FINK, THE RISE OF MUTUAL FUNDS, AN INSIDER'S VIEW 151-52 (2008). It was not clear, however, how they would invest in their communities, since their investors are usually nationwide. Fortunately, this proposal was not pushed through Congress, and the mutual funds were not forced to load up on subprime securities. Had they been required to do so, the economy surely would have been destroyed entirely.

18 Address by Federal Reserve Governor Randall S. Kroszner, *The Community Reinvestment Act and the Recent Mortgage Crisis,* Before the Confronting Concentrated Poverty Policy Forum, Washington D.C., on Dec. 3, 2008, *available at* http://www.federalreserve.gov/newsevents/speech/kroszner20081203a.htm.

FleetBoston Financial Corp. in 2003.[19] JPMorgan Chase made a larger $800 billion CRA pledge when it merged with Bank One Corp. The merger of Citibank and the Travelers Group in 1999 resulted in a ten-year $115 billion CRA pledge.[20] Washington Mutual made a CRA pledge of $120 billion in its 1998 acquisition of HF Ahmanson & Co.[21]

Both the Clinton and Bush (43) Administrations also pushed toward more subprime lending by two giant government sponsored enterprises ("GSEs"), Fannie Mae and Freddie Mac.[22] By 2000, about 50 percent of

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19 Craig Lender, *In Brief: B of A Chief Raps CRA Overhaul*, AMERICAN BANKER, Apr. 26, 2004, at 8.

20 REGULATION OF BANKING FINANCIAL SERVICE ACTIVITIES, *supra* note 16, at 405-06.

21 Jaret Seiberg, *Minority Report*, THE DAILY DEAL, Nov. 3, 2003.

22 As was reported in congressional hearings:

> One important turning point was the year 1995. The Clinton Administration embarked on a major policy, the National Homeownership Strategy (which led to the creation of the National Partners in Homeownership), designed to increase homeownership rates by encouraging broader financing among other things. At the same time, the Federal Reserve issued new regulations under the Community Reinvestment Act that, in the words of the Federal Reserve Governor who wrote the regulations, set up soft quotas on lending in underserved areas. Another quasi-government agency, the public-private Neighborhood Reinvestment Corporation, also helped set the stage for higher leverage in the housing industry. In 1995, it adopted a model down payment program with a 5 percent standard at a time. The Chairman of the Neighborhood Reinvestment Corporation is by tradition a Federal Reserve Governor, which effectively puts the government stamp of approval on any program. These relaxed standards, combined with a growing economy, allowed the underpinnings of the housing market to begin to erode. . . .
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> The requirement that homebuyers make significant down payments was eliminated in the 1990's. The National Partners in Homeownership (NPH) urged 13 and approved increasingly larger reductions in requirements. 'The partnership should support continued federal and state funding of targeted homeownership subsidies for households that would not otherwise be able to purchase homes. Notwithstanding the growing number of high loan-to-value mortgage products available today, many households, particularly low-and moderate-income families, will need subsidies to supplement down payment and closing funds or to reduce the monthly obligation on a home purchase mortgage'. 'In 1989 only 7 percent of home mortgages were made with less than 10 percent down payment. By August 1994, low down payment mortgage loans had increased to 29 percent'. This trend continued unabated throughout the 1990's so by 1999, over 50% of mortgages had down payments of less than 10%. In 1976, the average down payment by first time homebuyers was 18%, by 1999 that down payment had fallen to 12.6%. In 1999, more than 5% of all residential mortgages had no equity or had negative home-equity. Eliminating down payment barriers has created a homeownership option for Americans who previously were forced to rent, due to savings or credit issues. Over the past decade, Fannie Mae and Freddie Mac have reduced required down payments on loans that they purchase in the secondary market. Those requirements have declined from 10% to 5% to 3% and in the past few months Fannie Mae announced that it would follow Freddie Mac's recent move into the 0% down payment mortgage market. Although they are buying low down payment loans, those loans must be insured with 'private mortgage insurance' (PMI). On homes with PMI, even the closing costs can now be borrowed through unsecured loans, gifts, or subsidies. This means that not only can the buyer put zero dollars down to purchase a new house but also that the mortgage can finance the closing costs.

The Bush Administration continued the push to expand home ownership, and in 2002 President Bush adopted a specific goal of increasing the number of minority homeowners by 5.5 million by the end of the decade. The Federal Housing Agency had also lowered their standards and required only a 3 percent down payment to receive a government-backed FHA loan, and even this could be paid by a third party. As the housing sector started to pick up strength on the back of low interest rates and the their portfolios were subprime products.[23] That policy was carried forward by the Bush administration.[24] The 1992 Housing bill set "targets" for Fannie Mae and Freddie Mac to meet in making mortgages available to low and moderate income borrowers. Those targets were steadily increased, reaching 42 percent of these GSEs total lending by 1997. The result was that subprime lending grew from about 5 percent of all residential mortgage loans in 1994 to almost 20 percent by 2007.[25]

This figure did not provide the whole picture of the risks being injected into the system. Loans rated just above subprime were classified as "Alt-A" loans. The borrower in an Alt-A had an above subprime FICO score, but there was some defect in the loan such as little or no documentation ("no-doc" or "low-doc" loans) of the borrower's creditworthiness or other defects. In "stated-income loans," borrowers were allowed to state their income without documentation, earning them the sobriquet of "liar loans."[26] By 2006, 40 percent of all new mortgage originations were either subprime or Alt-A.[27]

III. BEHIND THE GROWTH OF SUBPRIME LENDING

The Federal Reserve Board has contended that the CRA did not cause the subprime crisis because many subprime loans did not have CRA credit.[28] However, that claim overlooks the fact that the CRA and government policy required and legitimatized subprime lending by institutions that had previously shied away from such business because of the risk it pre-

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2003 turn in the macroeconomy, the government pushed for even easier standards. On January 19, 2004, President Bush proposed eliminating the FHA's paltry 3 percent down payment with his 'Zero-Downpayment Initiative,' which would have allowed 150,000 people in the program's first year to take an FHA loan with no money down. While this proposal was not enacted, the private sector had long been following the government's lead and, in this bull market, was determined to outdo it. Rapidly rising home prices would make zero down loans available on a massive scale. By 2005, a remarkable 43 percent of all first time homeowners put zero down or took out a mortgage in excess of the value of the home. If home prices were rising 10 percent a year, a zero down loan would gain a 10 percent equity stake in just 12 months. Or so the logic went.

Hearing on Regulation of the Financial Sector Before the Committee of Senate Congressional Oversight Panel, Jan. 14, 2009, (statement of Marc Summerlin, Managing Member and Co-Founder, Lindsey Group) *available at* http://www.knowledgeplex.org/news/2901951.html.

23 *The Subprime Lending Bias*, INVESTOR'S BUSINESS DAILY, Dec. 22, 2008, at A14.

24 Howard Husock, *Housing Goals We Can't Afford*, N.Y. TIMES, Dec. 11, 2008, at A49. (By 2005, HUD required that 45 percent of all the loans bought by Fannie Mae and Freddie Mac be loans to borrowers with low and moderate incomes. HUD required further that Fannie and Freddie buy 32 percent of the loans in their portfolios from people in central cities and other underserved areas and that 22 percent of the loans they buy be to 'very low income families or families living in low-income neighborhoods.').

25 REGULATION OF BANKING FINANCIAL SERVICE ACTIVITIES, *supra* note 16, at 413.

26 Greg Griffin, *Local Lender Key in Meltdown Risky Mortgages, Aurora Loan Services' Fall Contributed to Lehman's Bankruptcy,* DENVER POST, Nov. 11, 2008, at A-01.

27 Hearing on Regulation of the Financial Sector, *supra* note 22.

28 Address by Federal Reserve Governor Randall S. Kroszner, *supra* note 18.

sented.[29] The government then opened the door, pushed the banks through and the banks then gorged themselves on what they believed to be a legitimate, socially responsible business for which they could model and hedge for its inherent risk.[30] Actually, the process might be better likened to supplying an alcoholic with the keys to the liquor cabinet and then forcing him to drink as much as possible. Whatever the case, although initially forced into the market by the government, investment banks soon found the business to their liking. By 2001, as the result of the CRA and other efforts, ten of the twenty-five largest subprime lenders were banks or their affiliates.[31]

Historically, subprime and Alt-A loans were more costly to the lender to originate, sell, and service than conventional prime loans.[32] Nevertheless, subprime loans did have their attractions. As with other mortgages, the lender made profits based on the spread between the funds it borrowed and those it lent to the subprime borrower. Subprime interest rates had a spread of 300 or more basis points over conventional loans, and the high origination and other fees charged for subprime loans tempted lenders to originate large amounts of subprime loans.[33] However, the default risk was traditionally too much for the appetite of the conventional investment banks. That problem was solved through securitization, which made meeting CRA pledges easy and enticed investment banks to plunge into this market. Once there, investment banks never looked back. They found the securitization process for subprime loans to be a profitable and enticing business. The investment banks then went on a binge of subprime originations and securitizations.

In a securitization, mortgages "warehoused" (purchased) by an investment bank from mortgage originators such as non-bank lenders and mortgage brokers are pooled into collateralized debt obligations ("CDOs") by a special purpose entity ("SPE"). Ownership interests in that pool are then sold to investors or are used to fund asset backed commercial paper programs ("ABCPs").[34] This effectively sold the pooled mortgages to the SPE that in turn sold them to investors as a pool, generating cash for new

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29 Former Federal Reserve Board Chairman Alan Greenspan testified before Congress in October 2008 that: "It's instructive to go back to the early stages of the subprime market, which has essentially emerged out of the CRA." Phil Gramm, *Deregulation and the Financial Panic*, WALL ST. J., Feb. 20, 2009, at A17.

30 As former Senator Phil Gramm recently opined: "It was not just that CRA and federal housing policy pressured lenders to make risky loans—but that they gave lenders the excuse and regulatory cover." *Id.*

31 Regulation of Banking Financial Service Activities, *supra* note 16, at 412.

32 United Companies Lending Corp. v. Sargeant, 20 F. Supp. 2d 192, 196 (D. Mass. 1998) (describing increased costs of subprime loans).

33 *See generally United Companies Lending Corp.*, 20 F. Supp. 2d 192.

34 *See* FDIC v. Bakkebo, 506 F.3d 286 (4th Cir. 2007) (describing this process). For a description of an ABCP program, see NationsBank, N.A. v. Commercial Financial Services, 268 B.R. 579 (N.D. Okla. 2001).

loans and moving the pooled loans off the bank's balance sheet. The SPE arrangement created a funding mechanism into which hundreds of billions of CRA and other subprime mortgages were eventually dumped.[35] Perhaps not ironically, Bear Stearns made the first CRA securitized offering in 1997, and Freddie Mac guaranteed it.[36]

Before investors would invest in these CDOs, they had to be assured that the investment was sound. As already noted, a subprime loan is by definition inherently risky. Financial engineers responded to that concern by providing differing payment streams from the SPE. The lower tranches in those payment schemes were required to absorb losses from defaults from non-government guaranteed subprime loans before the upper tranches could experience losses. Additional credit protection could be gained from credit default swaps ("CDSs")[37] or credit insurance from the so-called monoline insurance companies.[38]

Those protections convinced the rating agencies, which modeled for defaults, to give the upper tranches (commonly called "super seniors") of the CDOs a Triple-A rating, the gold standard for creditworthiness.[39] That AAA rating made these super seniors highly marketable, and they were sold

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35 Vincent M. Di Lorenzo, *Equal Economic Opportunity: Corporate Social Responsibility in the New Millennium,* 71 U. COLO. L. REV. 51 (2000) (describing the growth of CRA securitizations). "Warehouse" loans were also made by the investment banks to non-bank subprime originators in order to fund the loan to the homeowner. As one source noted:

> In 2002, five of the seven largest subprime originators in the land were nonbanks (Ameriquest, Household Finance, New Century, Option One and Homecomings), which meant they needed to borrow large sums of money to originate loans either through their branches or independent loan brokers. A warehouse line was a big loan—nothing more, nothing less—but without it there was no fuel to fire the origination machine that the subprime industry would turn into.

PAUL MUOLO & MATHEW PADILLA: CHAIN OF BLAME, HOW WALL STREET CAUSED THE MORTGAGE AND CREDIT CRISIS 183-184 (2008) [hereinafter MUOLO & PADILLA].

36 Russell Roberts, *How Government Stoked the Mania*, WALL ST. J., Oct. 3, 2008, at A21; Editorial, *The Subprime Lending Bias*, INVESTOR'S BUS. DAILY, Dec. 22, 2008 at A14.

37 A credit default swap has been defined as:

> a common type of credit derivative in which the protection buyer makes a fixed payment to the protection seller in return for a payment that is contingent upon a "credit event" —such as a bankruptcy—occurring to the company that issued the security (the "reference entity") or the security itself (the "reference obligation"). The contingent payment is often made against delivery of a "deliverable obligation" —usually the reference obligation or other security issued by the reference entity—by the protection buyer to the protection seller. This delivery is known as the "physical settlement."

Deutsche Bank AG v. Ambac Credit Products LLC, 2006 U.S. Dist. LEXIS 45322, at *5-6 (S.D.N.Y. 2006).

38 The monoline insurance companies initially provide credit guarantees for municipal bonds, but extended its guarantee business to mortgage backed securities, including subprime pools. Investopedia, http://www.investopedia.com/terms/m/monolineinsurance.asp (last visited Mar. 2, 2009).

39 For a description of super seniors and their attractions, see UBS AG, *Shareholder Report on UBS's Write-Downs* §4.2.3 (2008).

to investors and financial institutions all over the world. They were particularly popular with European banks.[40] The lower tranches were sold to investors who either accepted their exposure or hedged them with CDSs.

The subprime market was expanded massively through the securitization of subprime loans. Indeed, most subprime loans were securitized after their origination.[41] This left the investors in the CDOs holding the bag in the event of a default. A critical side effect to that transfer of risk was that loan originators such as mortgage brokers had no incentive to assure that the mortgage holder's already risky credit status was properly vetted. Rather, mortgage brokers were paid a "yield spread premium" that gave them an incentive to originate no matter how shaky the credit of the borrower.[42]

IV. SUBPRIME DANGERS

The investment banks initially just made warehouse loans to subprime lenders in order to fund their originations and bought those originations for securitizations. The investment banks then began purchasing the subprime mortgage originators themselves, with disastrous results for Merrill Lynch, Citigroup, Wachovia, and others.[43] This should come as no surprise. There had been an earlier subprime crisis in 1998-1999 during which large losses were experienced. That crisis resulted in the failure of several large subprime lenders that had become public companies.[44] Their failure was blamed on increased competition that resulted in a decline in credit quality, which is exactly what happened in the present crisis.[45] A large commercial

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40 As one article noted:

> The CDO structure depended on the concept of layered risk. The securities in the "super senior" top tier were considered low risk and attracted the highest ratings. In return for their safety, these bonds paid the lowest interest rate. The reverse was true at the other end; the lower tiers absorbed the first losses in the case of loan defaults. For accepting extra risk, investors in these tiers earned a higher interest rate.

Robert O'Harrow Jr. & Brady Dennis, *Downgrades And Downfall*, WASH. POST, Dec. 31, 2008, at AO1. *See also* James Quinn, *Bond Fund Titan Seeks $5bn for Mortgage-Backed Debts*, DAILY TELEGRAPH (London), Aug. 28, 2008, at City5 (describing effort to buy distressed super seniors from European banks).

41 By 2008, some $1.5 trillion of subprime and Alt-A mortgages had been securitized. Gretchen Morgenson, *Everyone Out of the Security Pool*, N.Y. TIMES, Nov. 16, 2008, at BU1.

42 Bob Tedeschi, *Report Piles Blame on Brokers*, N.Y. TIMES, Apr. 20, 2008, at RE10.

43 MUOLO & PADILLA, *supra* note 35, at 183-84.

44 *Id.* at 44-45, 239.

45 As one report noted:

> A number of factors have contributed to the recent decline in the health of the subprime industry. Increased competition is one of the most important factors. In 1994, there were only ten companies in the subprime lending business. By March of 1998, that figure had grown to fifty. Increased competition in the subprime market caused deterioration in overall credit quality. The proliferation of subprime lenders forced companies to go deeper into the credit pool to find customers. This reduction in credit quality has increased the risk of default. Moreover, consumer defaults have

bank was also badly burned by that first subprime crisis. Before its merger with Wachovia, First Union purchased the Money Store for $2.1 billion. However, First Union had to take a write down of $1.8 billion on that business after the subprime market had its first crash.[46]

Inexplicably, investment banks ignored that warning when they entered the subprime market in the new century. As Robert Rubin, the former Secretary of the Treasury and senior executive at Citigroup, noted in his autobiography (before the subprime crisis into which he had helped lead Citigroup) there is a tendency in human nature to engage in "financial excess" and that humans have a "remarkable failure to draw lessons from past experience. . . . The proclivity to go to excess is a phenomenon of collective psychology that seems to repeat itself again and again."[47] That warning proved to be prophetic for Citigroup and other investment bankers in their rush for the yields available from the high paying subprime pools, which had now been legitimatized by the federal government.

In 2003, investment bankers purchased and issued over $230 billion in subprime securitizations, almost double that of the prior year.[48] At first, the investment bankers were well rewarded for this effort.[49] They were happily reporting large profits in 2004 and 2005 from subprime lending and proprietary trading activities.[50] Their executives were given huge bonuses, but then the market turned.[51]

V. THE CRISIS

There was danger here that was real and apparent. Subprime loans were often funded by the lender at short-term rates and then loaned to the subprime borrower at higher long-term rates. This allowed a profit from

> been on the rise as the average American has taken on an increasing amount of debt. The industry was also hurt by the entrance of inexperienced subprime lenders who incorrectly evaluated customers' credit ratings and thereby made bad loan decisions. As the stock prices of subprime lenders dropped because of financial difficulties, institutions were less willing to provide the capital to subprime companies to finance further loans.

Evan M. Gilreath, *The Entrance of Banks into Subprime Lending: First Union and The Money Store*, 3 N.C. BANKING INST. 149, 153-54 (1999) (footnotes omitted).

46 Riva D. Atlas, *Wachovia Hopes SouthTrust Deal Repeats Success of 2001 Merger*, N.Y. TIMES, June 22, 2004, at C1.

47 ROBERT E. RUBIN & JACOB WEISBERG, IN AN UNCERTAIN WORLD, TOUGH CHOICES FROM WALL STREET TO WASHINGTON 318 (Paperback ed. 2004).

48 MUOLO & PADILLA, *supra* note 35, at 240.

49 Financial service firms contributed on average 22 percent of all earnings by S&P 500 companies between 1995 and the subprime crisis. The stock prices of financial service firms nearly doubled between 2003 and 2007. Gretchen Morgenson, *The End of Banking as We Know It*, N.Y. TIMES, Jan. 18, 2009, at BU1, 6.

50 *See* Louise Story, *After a Rough Year, Nearly Half of Wall Street Bank Profits Are Gone*, N.Y. TIMES, June 16, 2008, at C1 (describing those profits).

51 *See* Michael J. de la Merced, *Even for Rungs Below the Top, Goldman Bonuses Were Hefty*, N.Y. TIMES, Feb. 22, 2007, at C2 (describing the compensation of some of these executives).

the spread between the two, *i.e*. long term interest rates are normally higher than short-term rates. As long as yield spreads are constant, that spread creates a steady stream of profits from the CDOs created to fund subprime mortgages. However, that advantage becomes a liability when short-term interest rates rise faster than long term rates, cutting that profit margin.[52] That is exactly what happened when the Federal Reserve Board raised short-term interest rates, with seventeen straight increases between June 2004 and June 2006.[53]

Those interest rate increases had a twofold effect. CDOs funded with short-term paper were no longer profitable and refunding became a problem with the arrival of the credit crunch in 2007. Those rate increases also placed pressure on subprime borrowers because many of those loans were offered at "teaser" rates that would be reset at much higher rates than subprime lenders would be unable to afford.[54] In the rising market accompanying the real estate bubble, borrowers had been able to refinance their homes, pulling additional equity of the homes that allow them to service their debt and buy other, often unneeded, items. They lost that ability as housing prices declined when the bubble broke.

Subprime borrowers then became delinquent on their loans in increasingly large numbers and many of those delinquent loans went into foreclosure. By December 2008, about 4.5 percent of all first lien mortgages were 90 days or more delinquent or in foreclosure. One in ten Alt-A mortgages

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52 MUOLO & PADILLA, *supra* note 35, at 115.

53 *Shares Close Mixed as Earnings Reports Fail to Inspire*, N.Y. TIMES, Jan. 20, 2007, at C1.

54 Roger Lowenstein, *Triple-A Failure*, N.Y. TIMES, Apr. 27, 2008, at MM36. Mortgage loans with non-conventional terms were authorized in 1982 when Congress passed the Alternative Mortgage Transactions Parity Act (AMTPA") (12 U.S.C. §§3801-06). That legislation attempted to stimulate lending by loosening regulatory restrictions that had previously allowed savings and loan associations to make only conventional fixed-rate, fixed-term loans. AMTPA allowed home equity lines of credit as second mortgages on residences and adjustable rate mortgages ("ARMs"). It also allowed loans with an initial low interest rate (the "teaser" rate) that was adjusted after a short period into a variable index interest rate plus an additional number of points. For example, a so-called "2/28 ARM" had a fixed rate for two years and then adjusted to a floating rate for the remaining twenty-eight years of the loan. The spread over the index rate then usually ranges from 300 to 600 basis points. This is called "payment shock" in the business. Interagency Statement on Subprime Mortgage Lending, 72 Fed. Reg. 37569, at nn. 10-11 (July 10, 2007).

Another innovation was the "reverse mortgage." These mortgages allow individuals to take out a loan that would pay them either a large lump sum or periodic payments that were secured by the equity in the home. Thus, instead of the homeowner paying the bank a monthly mortgage payment, the bank would make payments to the homeowner. Of course, the homeowner was spending the equity accumulated in the house, which was inflated by the ongoing market boom. These mortgages were particularly popular with the elderly who saw it as a good way to cash in on their home without moving. "Reverse mortgages" were widely sold to seniors by retired actors that allowed elderly homeowners to take draw downs on the equity accumulated in their homes over the years. These payments assured participating seniors a guaranteed source of income. Reverse mortgage payments were not taxable, and repayment did not have to be made until the senior left or sold the residence. *See generally* Wolfert v. Transamerica Home First, 439 F.3d 165 (2d Cir. 2006) (describing reverse mortgages).

were delinquent and more than 20 percent of subprime mortgages were delinquent or in foreclosure. The number of foreclosures in 2008 reached nearly 2.25 million, up from an annual rate of only about one million per year before the subprime crisis.[55] In Lee County, Florida, judges were authorizing 1,000 foreclosures per day.[56]

The effects of the Federal interest rate increases were devastating to the large investment banks. The thirty years following the first Bear Stearns offering of securitized subprime loans would destroy that venerable firm and push Wall Street into the subprime crisis.[57] Merrill Lynch then had to be rescued by Bank of America, which then had to be rescued by the government as losses at Merrill Lynch continued to grow.[58] The banking giant Wachovia was brought down by losses from a subprime lender Wachovia had bought to gain market share in such lending.[59] Wachovia had to be rescued by Wells Fargo.[60] Washington Mutual failed and was rescued by JPMorgan Chase.[61] Fannie Mae and Freddie Mac were placed in conservatorship.[62] European banks, including UBS AG suffered massive losses. The Royal Bank of Scotland had to be nationalized.[63]

In a market test of systemic risk, the government allowed Lehman Brothers to fail, which touched off a frightful panic in the credit markets and on the stock exchanges.[64] A horrifying run began on the money market funds, after the Reserve Primary Fund announced that it would "break-the-buck" because of losses from exposures to Lehman Brothers debt. That panic was quelled only after the government announced it would be guaranteeing money market funds.[65]

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55 Ben S. Bernanke, Address at the Federal Reserve System Conference on Housing and Mortgage Markets (Dec.4, 2008). The percentage of Alt-A loans that were delinquent quadrupled in April 2008 over the prior year. Vikas Bajaj, *Housing Lenders Fear Bigger Wave of Loan Defaults*, N.Y. TIMES, Aug. 4, 2008, at A1. FRB: Charge-Off Rates; All Banks, NSA, The charge-off rate for residential mortgages by commercial banks went from 0.09% in 1996 to 1.45% in March of 2008. http://www.federalreserve.gov/ releases/chargeoff/chgallnsa.htm. (last visited Mar. 2, 2009).

56 Michael Corkery, *A Florida Court's 'Rocket Docket' Blasts through Foreclosure Cases*, WALL ST. J., Feb. 18, 2009, at A1.

57 Susanne Craig et al., *The Weekend That Wall Street Died—Ties That Long United Strongest Firms Unraveled as Lehman Sank Toward Failure*, WALL ST. J., Dec. 29, 2008, at A1.

58 Dan Fitzpatrick, et al., *Crisis on Wall Street—Bank Stress: BofA's Latest Hit—Treasury Injects $20 Billion More; Stock at 1991 Level*, WALL ST. J., Jan. 16, 2009, at C1.

59 Michael Moss & Geraldine Fabrikant, *Once Trusted Mortgage Pioneers, Now Pariahs*, N.Y. TIMES, Dec. 25, 2008, at A1.

60 Eric Dash & Ross Sorkin, *Regulators Push for Sale of Wachovia*, N.Y. TIMES, Sept. 29, 2008, at A15.

61 Peter Y. Hong, *State Foreclosure Pace Slows*, L.A. TIMES, Jan. 13, 2009, at C2.

62 *Paulson Sees Changes for Freddie and Fannie*, N.Y. TIMES, Jan. 8, 2009, at B6.

63 David Olive, *2008 A Year of Turmoil*, TORONTO STAR, Dec. 30, 2008, at BO1.

64 Jo Becker, et al., *White House Philosophy Stoked Mortgage Bonfire*, N.Y. TIMES, Dec. 21, 2008, at A1.

65 Diana B. Henriques, *Money Market Funds Are a Refuge, Right?,*N.Y. TIMES, Jan. 11, 2009, at BU17.

In total, large investment banks wrote down over $150 billion in subprime mortgages by March 2008, and that amount was expected to double.[66] The stock values of most large financial institutions were smashed.[67] The last two large independent investment banking firms, Morgan Stanley and Goldman Sachs, converted to bank-holding companies in order to qualify for government bailouts.[68] Citigroup also sustained massive loses from subprime structured investment vehicles ("Sivs" or more appropriately "SIEVs") and was saved only by a massive federal rescue package. That giant financial supermarket, which had become a market model, is being split up into more traditional lines.[69] The contagion spread to the American International Group, which had to be bailed out by the federal government with a $170 billion rescue package.[70]

Credit markets were frozen and liquidity became absent. The federal government mounted a momentous effort to deal with this crisis. Over a period of several months, interest rates were slashed down to near zero, unprecedented in U.S. history.[71] Credit lending facilities were made available to financial service firms that were non-prime dealers, and later those facilities were extended to commercial firms when the commercial paper markets froze after the collapse of Lehman Brothers. A facility was also created to purchase asset-backed commercial paper from money market mutual funds.[72] After an initial rejection,[73] the Targeted Asset Relief Program ("TARP"), the $700 billion bailout program for financial service firms, was passed by Congress to inject capital into those struggling institutions.[74] FDIC insurance was increased to $250,000, and an FDIC guarantee was extended to debt issuance by financial service firms.[75] This, of course, created an increased, moral hazard.

In the meantime, the economy fell into recession. Unemployment rates were up, while sales and manufacturing were trending sharply downward. The housing market was in a near historic slump as new housing

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66 Standard & Poor's, *Subprime Write-Downs Could Reach $285 Billion, But Are Likely Past The Halfway Mark*, Mar. 13, 2008, *available at* http://www2.standardandpoors.com/portal/site/sp/en/us/page.article/4,5,5,1,120483 4027864.html.

67 In 2007, financial service companies supplied about 22 percent of the market value of the S&P 500 index. As 2009 began, that number had dropped to 12.5 percent. Gretchen Morgrnson, *The End of Banking as We Know It*, N.Y. TIMES, Jan. 18, 2009, at BU1, 6.

68 Dennis K. Berman, *The Game: Answering Morgan Stanley Riddle—CEO Selection Holds Key to What the Firm, and Wall Street, Become,* WALL ST. J., Jan. 6, 2009, at C1.

69 Andy Kessler, *The End of Citi's Financial Supermarket*, WALL ST. J., Jan. 16, 2009, at A11.

70 Ron Lieber, *Your Insurance Company, and Related Worries*, N.Y. TIMES, Nov. 15, 2008, at B1.

71 Edmund L. Andrews, *Fed's Minutes Reveal Shock at Downturn*, N.Y. TIMES, Jan. 7, 2009, at B1.

72 http://www.federalreserve.gov/newsevents/press/monetary/20081202b.htm.

73 Robert Pear, *Reconsidering a Key Vote, Under Intense Pressure*, N.Y. TIMES, Oct. 4, 2008, at A11.

74 12 U.S.C.A. §§5202 *et seq*. (2008).

75 Tara Siegel Bernard, *Reassessing Safety of Bonds*, N.Y. TIMES, Dec. 27, 2008, at B1.

starts dwindled to a fifty-year low[76] and existing home sales dropped.[77] This had a ripple effect throughout the economy as construction workers were laid off, real estate agents idled, mortgage brokers closed, and other direct and indirect participants in the real estate market were sidelined.[78] The automakers were also in extremis as automobile sales plunged. Chrysler and General Motors were saved from bankruptcy, at least temporarily, by a cash infusion from the federal government in the waning days of the Bush administration.[79]

VI. SELL SIDE REFORMS—TREASURY BLUEPRINT

The subprime crisis has given rise to a cry for more regulation, whatever its form and whatever its efficacy. Fortunately, there is all ready on the table a proposal by the Treasury Department for a comprehensive reform of U.S. financial services regulation that reflects common sense, rather than hysteria.[80] That proposal was a result of a study conducted by Treasury in response to concerns over the existing financial regulatory system.[81] Ironically, those concerns were focusing on the effects of too much regulation, particularly the Sarbanes-Oxley Corporate Reform Act of 2002.[82]

As a part of its study, the Department sought public comment on a number of issues concerning the existing financial regulatory structure. Of particular interest was the Department's request for comment on whether the "increasing convergence of products across the traditional 'functional' regulatory lines of banking, insurance, securities, and futures" justifies changes in the regulatory system to assure that regulatory boundary lines do not unnecessarily inhibit competition.[83] The Department received over 350

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76 Jack Healy, *Markets Finish Little Changed Despite Bleak Reports on Housing*, N.Y. TIMES, Feb. 19, 2009, at B3.

77 Jack Healy, *October Report Shows Home Prices Down 18% From Last Year*, N.Y. TIMES, Dec. 31, 2008, at B3.

78 By the middle of February 2009, the U.S. had lost 3.6 million jobs and the unemployment rate reached 7.6 percent, the highest such rate in sixteen years. *High Anxiety*, NEWSDAY (New York), Feb. 19, 2009, at A39.

79 Jim Jelter, *Corporate News: GM Wins New Loan Facility*, Wall St. J., Jan. 3, 2009, at B5.

80 Department of the Treasury, Blueprint for a Modernized Financial Regulatory Structure (Mar. 2008) (hereinafter "Treasury Blueprint").

81 72 Fed. Reg. 58939 (Oct. 17, 2007). A number of blue-ribbon committees had examined the U.S. financial regulatory structure and concluded that it was impairing the nation's ability to compete in financial services in a global market. *See* Mayor of New York, Michael R. Bloomberg & Senator Charles E. Schumer, Sustaining New York's and the US Global Financial Services Leadership (Jan. 2007); Committee on Capital Markets Regulation, the Competitive Position of the U.S. Public Equity Markets (Dec. 4, 2007); Committee on Capital Markets Regulation, the Competitive Position of the U.S. Public Equity Markets (Dec. 4, 2007); Commission on the Regulation of U.S. Capital Markets In the 21st Century (U.S. Chamber of Commerce March 2007); and Financial Services Roundtable, "The Blueprint for U.S. Financial Competitiveness (2007).

82 Sarbanes-Oxley Corporate Reform Act of 2002, Pub. L. No. 107-204, 116 Stat.745 (2002).

83 72 Fed. Reg. 58939 (Oct. 17, 2007).

comment letters on this topic.[84] This was obviously a subject that the financial community thought was important.

The Treasury Department then published its "Blueprint" for financial services regulatory reform that recommended a broad restructuring of this chaotic financial services regulatory structure.[85] Not surprisingly, the Blueprint expressed concern that functional regulation was ineffective and was undermining America's traditional competitive advantage in financial services.[86] The Blueprint prophetically asserted that functional regulation "exhibit[ed] several inadequacies, the most significant being the fact that no single regulator possesses all of the information and authority necessary to monitor systemic risk, or the potential that events associated with financial institutions may trigger broad dislocation or a series of defaults that affect the financial system so significantly that the real economy is adversely affected."[87]

The Blueprint contrasted the functional regulatory approach in America with regulatory mechanisms abroad. England Germany, Japan and dozens of other countries use a consolidated regulator, along with a central bank, to impose regulation through a single rulebook approach.[88] Those countries also eschew the "rules-based" approach used by most of the multitude of regulators in the United States. Rather, those overseas regulators use a "principles" based approach that generally prescribes the goals of regulation and allows the industry to choose how to reach those goals.[89]

Interestingly, the Treasury Blueprint declined to adopt a single regulator approach, probably because of objections by the existing regulators. Instead, the Blueprint recommended that the United States adopt a so-called "Twin Peaks" approach to regulation that is used in Australia and the Netherlands.[90] The Twin Peaks approach is objectives-based and focuses on specific regulatory goals. The concept of twin peaks envisions some regulatory

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84 U.S. Treasury Assistant Secretary for Financial Institutions David G. Nason, Remarks Before the City of London Corporation, Redesigning U.S. Financial Regulation for a Global Marketplace (Dec. 11, 2007), *available at* http://www.treas.gov/press/releases/hp726.htm.

85 Treasury Blueprint, *supra* note 80.

86 The Blueprint noted that:

> Due to its sheer dominance in the global capital markets, the U.S. financial services industry for decades has been able to manage the inefficiencies in its regulatory structure and still maintain its leadership position. Now, however, maturing foreign financial markets and their ability to provide alternate sources of capital and financial innovation in a more efficient and modern regulatory system are pressuring the U.S. financial services industry and its regulatory structure.

Treasury Blueprint, *supra* note 80, at 2.

87 *Id.* at 4.

88 *Id.* at 141.

89 An exception is the Commodity futures Trading Commission that adopted a principles-based regulatory system under the Commodity Futures Modernization Act of 2000. Pub. L. No. 106-544, 114 Stat. 2763.

90 Treasury Blueprint, *supra* note 80, at 142

consolidation, particularly through the creation of bodies that would focus on prudential supervision, market stability and a single business practices regulator that would govern business conduct and consumer protection.

The Treasury Blueprint also sought to expand federal charters to most large financial institutions including insurance companies that, heretofore, have escaped federal regulation. The optional federal charter for insurance companies would remove insurance electing such a charter to escape the scrutiny of 50 state insurance regulators. Under the Treasury Blueprint, a federal Office of National Insurance would oversee the federally chartered insurance companies.[91]

The regulatory structure proposed by the Blueprint would preempt most other state regulation of financial institutions. However, this would cut off the career paths of many budding state politicians who witnessed the rise of Eliot Spitzer to become a national figure as a result of his attacks on Wall Street. Spitzer's successor, Andrew Cuomo, is now the most recent and prominent of these wannabes. Naturally, the states were not about to take this recommendation lying down. The North America Securities Administrators Association ("NASAA") announced its own plan for reform on November 19, 2008 that recommended the preservation of state and federal regulation, but admitted that some streamlining might be in order. NASAA advocated, however, that all financial products and markets be subject to regulation so that there would be no regulatory gaps. It was in favor of principles based regulation, but only as an additional layer to existing rules. It also wanted to toughen enforcement and strengthen private remedies.[92]

The Treasury Blueprint faced other obstacles. It was issued just before the subprime crisis was in full bloom, so it did not fully address the problems in that market. The Blueprint did recommend that mortgage brokers be regulated[93] and that Fannie Mae and Freddie Mac be restructured, a recommendation that came before their failure.[94] There were other players that attracted regulatory interest outside the Blueprint as the subprime crisis exploded. These included the non-bank lenders that built the subprime market in the 1990s, many of which failed on their own[95], such as the Countrywide Financial Group that had to be rescued by Bank of America,[96] and

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91 Treasury Blueprint, *supra* note 80, at 128-33.

92 NASAA to Host Financial Services Regulatory Reform Roundtable. http://www.nasaa.org/NASAA_Newsroom/Current_NASAA_Headlines/9910.cfm (last visited Jan. 10, 2009).

93 Treasury Blueprint, *supra* note 80.

94 *Id.*

95 PAUL MUOLO & MATHEW PADILLA, Chain of Blame, HOW WALL STREET CAUSED THE MORTGAGE AND CREDIT CRISIS 44-45, 239 (2008).

96 Louise Story and Julie Creswell, *Love Was Blind*, N.Y. TIMES, Feb. 8, 2009, at BU1.

many others which were acquired by and caused the failure of the large investment banks.[97]

VII. REGULATION IN A TIME OF HYSTERIA

Unfortunately, the careful analytical approach taken by the Treasury Blueprint is being abandoned. The present climate of political hysteria suggests that more regulation will simply be heaped onto the existing structure without regard to its cost or efficacy. But just adding more regulation for regulation sake or to punish failed business executives is not a solution. Such regulatory efforts solve no problems and will only make recovery more difficult. Focus should, instead, be on the causes of the problems that led to the subprime crisis and how best to deal with those issues.

To be sure, there is plenty of blame to go around. To name a few: there is the Congress and the administrations of Bill Clinton and George W. Bush that pushed the banks and GSEs into the subprime market; regulators of every stripe who failed to anticipate the collapse of the subprime market; mortgage lenders who abandoned many of the most basic credit assessment guidelines; mortgage brokers that originated subprime mortgages for fees regardless of the creditworthiness of the borrower; rating agencies that under estimated the risks of subprime securitizations; appraisers that inflated their reports; [98] and the under-capitalized monoline insurers that failed to recognize the risks from subprime lending.[99]

Those actors may be in need of scrutiny to define the reasons behind their failures so that more caution can be exercised in the future. But more

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97 For Example, Merrill Lynch acquired First Franklin, Wachovia acquired Golden West Financial Corp., and Citigroup acquired Associates First Capital Corp. *See* Paul Muolo & Mathew Padilla, Chain of Blame, How Wall Street Caused the Mortgage and Credit Crisis 24-26 (2008); Michael Moss & Geraldine Fabrikant, *The Reckoning*, N.Y. Times, Dec. 25, 2008, at A1; Eric Dash, *Citigroup Buys Parts of a Troubled Lender*, N.Y. Times, Sept. 1, 2007, at C4.

98 John Leland, *Officials Say They are Falling Behind on mortgage Fraud Cases*, N.Y. TIMES, Dec. 25, 2007, at A18.

99 The monolines simply did not have the capital to support their subprime guarantees. Because of modeling errors, they underestimated the risk from those guarantees and were forced to default as the subprime market became unglued. The result was that the monoline insurers had their credit ratings downgraded, which in turn caused the instruments they graded as AAA to be downgraded. *See generally* Alison Tudor, Nomura, *Daiwa Profits On Way Up, Shares Not —Weak Momentum Behind Earnings Fails to Fuel Rally*, WALL ST. J., July 25, 2008 at C2 (describing losses from such downgrades). One of the larger monolines, MBIA announced MBIA announced in February 2009 that it was dividing itself into two arms, one for municipal bond insurance and the other for structured investments and other non-municipal business. MIBIA denied that this was an effort to create a "good bank—bad bank" structure. In the meantime the market for new municipal bond offerings had froze because of concerns with the stability of MIBIA and other municipal bond insurers. Serena Ng, *Crisis on Wall Street -- MBIA's Toxic Cleanup: Carving Out Muni Unit*, WALL ST. J., Feb. 19, 2009, at C3.

The monolines were not regulated under state insurance laws because their credit guarantees were not viewed to be an "insurable interest" that would fall within the insurance statue. *See generally* New York State Department of Insurance, Office of General Counsel, Opinion concerning Weather Financial Instruments (derivatives, hedges, etc.), Feb. 15, 2000 (discussing this concept).

regulation simply because of a failure of business judgment provides no panacea. Regulation has never prevented failure before, why should we expect that it would do so in the future? Indeed, the investment banks that failed were among the most heavily regulated institutions in the world, but regulation did not prevent their failure. Another good example of the fallacy of adding more regulation without consideration of its efficacy is the rating agencies that were subject to regulation by the SEC after they continued to give high ratings to Enron, WorldCom and others until just before their collapse.[100] Even now more regulation is being heaped on the rating agencies by the SEC as the result of their modeling errors in granting Triple-A ratings to thousands of subprime instruments that had to be subsequently downgraded to junk bond status.[101] Undoubtedly, that regulation will have no effect on the prevention or prediction of future crises.

Instead of adding more regulation for regulation's sake, focus is needed on the failures that actually led to the crisis. The problems that lie at the heart of the subprime crisis are, first and foremost, federal housing policy that forced banks to make loans on the basis of social policy, rather than the credit worthiness of the borrower. To the extent the government wishes to encourage homeownership for the poor that should have been done by direct subsidies, not through coercive lending policies imposed on private sector banks. Banks should return to extending credit based solely on the ability of the borrower to service the debt.

Another culprit in the subprime crisis is the accounting requirement for "fair value" treatment of subprime and other tradable assets. Under "fair value" accounting requirements those securities had to be valued at existing price levels. However, the subprime market was frozen and the only available prices were at distressed fire sale prices.[102] The fair value accounting requirement required banks to value their subprime exposures at those distress prices even though they might not reflect the actual value of the in-

100 *See* The Credit Rating Agency Reform Act of 2006 (109 Pub. L. No. 291, 120 Stat. 1327, codified at 15 U.S.C. §780-7). The rating agencies had been used by the SEC, bank regulators and the CFTC as a means for valuing instruments for capital requirements and other purposes, including limitations on the investments of money market funds. The rating agencies were designated as "nationally recognized statistical rating organizations" (NRSROs") for that purpose. Jerry W. Markham & Thomas Lee Hazen, 23 Broker Dealer Operations Under Securities and Commodities Law: Financial Responsibilities, Credit Regulation, and Customer Protection §4:22.50 (2008).

101 *See* Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies (SEC July 2008) (describing defects in credit rating agency procedures for rating mortgage-backed debt And discussing proposed new regulations). Lloyd Blankfein, the CEO of Goldman Sachs, has asserted that financial institutions erred in outsourcing their risk management to the rating agencies. He charged that the rating agencies had diluted the Triple A rating by giving that gold standard rating to over 64,000 structured finance instruments, while only 12 companies in the entire world held such a high rating. Lloyd Blankfein, *Do Not Destroy the Essential Catalyst of Risk*, FINANCIAL TIMES (London), Feb. 9, 2009, at 7.

102 Emily Chasen, Is Fair Value Accounting Really Fair? Reuters, Feb. 26, 2008, http://www.reuters.com/article/reutersEdge/idUSN1546484120080226.

strument on a long term basis. This requirement resulted in massive write downs of subprime assets on the books of financial service firms.[103] The effect of those write downs was to cause the investment banks to report massive losses that completely undercut their share prices and destroyed their credibility in the market. Under such circumstances, cash flow, historical cost or other recognized valuation methods should be used instead of artificial values derived from a market dislocation caused by a panic. Unfortunately, such reform is unlikely as the SEC and other government bodies continue to defend fair value accounting, blaming the failures of banks and investment banks on other problems, calling it a "run on the bank."[104] It is not as if we learn from past events:

> What many people do not realize is that mark-to-market accounting existed in the Great Depression and, according to Milton Friedman, was an important reason behind many bank failures. In 1938, Franklin Delano Roosevelt called on a commission to study the problem and the rule was finally suspended.[105]

Another flaw that must be addressed is really the key to the whole subprime disaster. Mathematical models used by the underwriters of subprime securitizations, the monoline insurers, the rating agencies and the investment banks all failed. Risk modeling took on new importance in financial markets with the creation of the Black-Scholes options pricing model in 1973.[106] This pricing formula gave rise to a widespread belief that the risks from complex financial instruments could be scientifically predicted with some degree of certainty. For example, a risk model developed by David Li, a "Gaussian Copula" model, did for collateralized debt obligations ("CDOs) what Black-Scholes did for options, it was thought to have allowed CDOs to be valued through mathematical formulas.[107] In wide-

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103 Liz Moyer, *How fair is Fair Value Accounting?*, Forbes.Com, June 25, 2008, *available at* http://www.forbes.com/2008/06/24/accounting-banking-sec-biz-cx_lm_0625sec.html.

104 SEC, Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-to-Market Accounting 3 (Dec. 30, 2008). Congress directed the SEC to consider whether fair value accounting should be suspended, but the SEC declined to do so. S.E.C. Elects to Keep Mark-to-Market Rules, N.Y. Times, Dec. 31, 2008, at B2. Accounting authorities eventually allowed alternate valuations through cash flow assessments when there was a "temporary" impairment in value. Banks Get Break With 'Fair Value,' Newsday, Oct. 11, 2008, at A20. However, that action was too little and too late to save the investment banks and there was much confusion over what was temporary.

105 Brian S. Wesbury and Robert Stein, *Mr. President, Suspend Mark-To-Market*, Forbes.com, January 21, 2009, http://www.forbes.com/2009/01/20/accounting-treasury-obama-oped-cx_bw_rs_0121wesburystein.html.

106 http://www.riskglossary.com/link/black_scholes_1973.htm.

107 This was a computerized model that weighed the likelihood that the companies whose leveraged loan debt is placed in a CDO will default. It was based on the "broken heart" concept familiar to actuaries, *i.e.*, individuals die faster than they otherwise do after the death of a spouse. The CDO model uses risk assessments for each leveraged loan in the CDO and then correlates those risk assessments to

spread use were the value at risk ("VAR") models that financial institutions used to assess the risk from their portfolios and proprietary trading.[108] Those models even became the basis for capital requirements in Basel II for banks worldwide.[109] However, those VAR models failed to predict the massive losses sustained by commercial banks in the United States and Europe from subprime exposures.

The use of VAR models for setting capital requirements was extended by the SEC in recent years to the large investment banks that it regulated through the concept of "consolidated supervised entity" treatment.[110] The failures of Bear Stearns, Lehman Brothers, Merrill Lynch and problems at Morgan Stanley were blamed on the adoption of the consolidated supervised unity status for those firms.[111] "Under the traditional [SEC net capital rule] rule, broker-dealers could not exceed a 12-1 [leverage] ratio, but when Bear Stearns became insolvent, its debt-to-capital ratio was 33-to-1; at the time of its merger agreement, Merrill's was reportedly 40-to-1."[112]

All of these models failed during the subprime crisis. In retrospect, the reason for this is quite clear. Those models relied on historical prices generated by a rising market that overlooked the perfect storm that became the subprime crisis. They made no allowance for the hundred-year storm, the "black swan," the "fat tail" outliers that occurred during the subprime cri-

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determine the likelihood of defaults that would affect the lowest tranches in the CDO. Steven Hsu, Gaussian Copula and Credit Derivatives, http://infoproc.blogspot.com/2005/09/gaussian-copula-and-credit-derivatives.html (Sept. 12, 2005).

108 *See generally* Elene Spanakos, *Harmonization of International Adequacy Rules for Securities Firms: An Argument to Implement the Value at Risk Approach by Adopting Basil's Internal Model Methodology*, 26 BROOKLYN J. INT'L L. 221 (2000) (discussing the role of VAR).

109 However, Basel II was not fully agreed upon by federal regulators in the U.S. until July 2007. David Wighton, *Deal eached on Applying Basel Rules*, FINANCIAL TIMES (London), July 21-22, 2007, at 2.

110 Securities Exchange Act Release No. 34-54255 (July 31, 2006). The consolidated supervised unity status regimen was actually a requirement imposed by the European Union on banks and other financial service firms operating within its borders, which of course included the large U.S. investment banks. The SEC acted through its consolidated supervised entity program to accommodate that requirement. Jerry W. Markham & Thomas Lee Hazen, 23 Broker Dealer Operations Under Securities and Commodities Law: Financial Responsibilities, Credit Regulation, and Customer Protection §4:42.50 (2008).

111 Stephen Labaton, S.E.C. Concedes Oversight Flaws Fueled Collapse, N.Y. TIMES, Sept. 27, 2008, at A1. Previously, the SEC had applied its net capital rule, a liquidity measure, to those firms. 17 C.F.R. §15c3-1.

112 John Sandman, *CSE Program A Failed Experiment, Financial Times Securities Industry News*, http://www.lexis.com/research/retrieve?_m=d7aff10dba98c40c875.ca487a589f559&docnum=2&_fmtstr=FULL&_startdoc=1&wchp=dGLbVlWzSkAW&_md5=d3869cf0f4e3b95b7023c520f51b7f02&focBudTerms=capital%20and%20consolidated%20supervision%20 and%20SEC&focBudSel=all. Risk-based capital models were also adopted by the CommodityFTC, but with better results because it was tied to exchange margin requirements that more accurately valued risks. 69 Fed. Reg. 49784 (Aug. 12, 2004).

sis.[113] However, as we have now learned, once again, a hurricane Katrina will strike on occasion. Risk models must account for this possibility.

Lloyd Blankfein, the CEO at Goldman Sachs, published an op-ed piece in the *Financial Times* in which he identified what he believed were the flaws in the financial system that had led to the subprime crisis. They are worthy of attention. He points risk management failures as the problem, such as over reliance on risk modeling that did not take into account "multiple standard deviation of events."[114] Risk managers also erroneously assumed positions could be fully hedged, and they failed to account for off-balance-sheet risks. Blankfein further thought that the investment banks had not been able to keep up operationally with the complexity of the risks presented by new financial instruments.[115]

Blankfein was right to have targeted these practices. The risks from subprime mortgages were simply passed in a circle in many instances or dumped on a party that did not have the capital to absorb the loss. If these risks had been properly modeled, counterparty assessment would have been more thorough, and many subprime mortgages would never have been originated because no buyer would accept them.

VIII. BUY SIDE REFORMS—MORTGAGE REFORMATIONS

Most attention during the Bush administration was focused on the sell side of the mortgage market during the subprime crisis, which essentially meant bailing out the financial institutions that were so badly damaged by their participation in that market. Many critics contended that more focus should have been placed on aiding homeowners who were losing their homes by the thousands as foreclosures mounted.

On July 30, 2008, President Bush signed into law the HOPE for Homeowners Act[116] that allowed the Federal Housing Authority ("FHA") to insure up to $300 billion in new refinanced mortgages for poor and dis-

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113 Value at risk models failed to account for unusual market events. Those outliers were a well known danger. *See* NASSIM NICHOLAS TALEB, THE BLACK SWAN, THE IMPACT OF THE HIGHLY IMPROBABLE xviii (2007) (describing the dangers of events that have low predictability and large impact and noting that portfolio managers use risk assessment measures that exclude the possibility of a black swan).

114 Blankfein also believed that companies had not accurately priced the subprime instruments held in their portfolios. He asserted that Goldman Sachs practice of daily marking of positions to market allowed it to avoid the worst of the subprime losses. Lloyd Blankfein, *Do Not Destroy the Essential Catalyst of Risk*, FINANCIAL TIMES (London), Feb. 9, 2009, at 7.

115 Blankfein also believed that companies had not accurately priced the subprime instruments held in their portfolios. He asserted that Goldman Sachs practice of daily marking of positions to market allowed it to avoid the worst of the subprime losses. Lloyd Blankfein, Do Not Destroy the Essential Catalyst of Risk, *Financial Times* (London), Feb. 9, 2009, at 7.

116 Pub. L. No. 110-289, 122 Stat. 2800 (July 30, 2008).

tressed borrowers.[117] It was initially estimated that this would allow some 400,000 homeowners to refinance their mortgages on more favorable terms by converting them into government guaranteed mortgages.[118] However, the institutions underwriting the original loans would have to forgive some of the principal because the refinanced mortgages could not have more than a 90 percent loan to value ratio.[119] This would require the lender to reduce the amount of the mortgage to that level. Since housing prices were falling rapidly that could be a significant write off. Another problem was that many of the mortgages otherwise qualifying for the program had been securitized. In order to adjust the terms of the underlying mortgages in those securitized pools, at least in some instances, approval of the investors purchasing the instruments would be required. Only 357 individuals signed up for this voluntary program and only a handful of mortgage holders had received any relief under the program by February 2009.[120] The Department of Housing and Urban Development blamed this little amount of applications on high fees and restricted eligibility requirements.[121] As a result only a handful of mortgages were refinanced under this program.

The Bush Administration announced the creation of a program called Hope Now in October 2007. This was an alliance between the Department of Housing and Urban Development, mortgage lenders and loan counselors that was intended to provide voluntary assistance and counseling to homeowners in trouble with their mortgage. Within a few months, some 4,500 persons were calling the Hope Now hot line each day, but were receiving little assistance in dealing with their mortgage paayments.[122]

In December 2007, at the request of Henry Paulson, Secretary of the Treasury Department, several large mortgage lenders agreed to create new programs that would allow potentially defaulting subprime borrowers to refinance their mortgages on more affordable terms or to freeze their float-

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117 Kevin G. Hall, *Public Sector Eyes New Ways to Absorb Private Insolvency*, CHATTANOOGA TIMES FREE PRESS (Tennessee), Dec. 5, 2008, at C3.

118 Evan Page, *Federal Housing Help Falls Short: The Housing and Economic Recovery Act of 2008*, 21 LOY. CONSUMER L. REV. 249, 254 (2008).

119 http://banking.senate.gov/public/_files/HousingandEconomicRecoveryActSummary.pdf. The legislation also created an Affordable Housing Trust Fund that was to be financed by $900 million in fees from Fannie Mae and Freddie Mac, which subsequently failed. David M. Herszenhorn, *Approval is Near for Bill to Help U.S. Homeowners*, N.Y. TIMES, June 25, 2008, at A1.

120 Statement of John Taylor President & Chief Executive Officer National Community Reinvestment Coalition Committee on House Financial Services on Feb. 3, 2009, available athttp://www.lexis.com/research/retrieve?_m=2468b380eae69085cc5669b7d49546ee&docnum=4&_fmtstr=FULL&_startdoc=1&wchp=dGLbVzb-zSkAA&_md5=96b8235b94dbabbe1e4de08098cd209f&focBudTerms=hope%20 and%20357%20and%20foreclosure&focBudSel=all.

121 Another program called FHASecure was developed to provide relief to some 80,000 homeowners who were delinquent on adjustable interest rate resets. However, that program provided relief to only 4100 homeowners and the program was dropped at the end of December 2008. Brian Collins, HUD Kills FHA Secure Effort, 33 Nat'l Mtg. News 15 (Jan. 5, 2009).

122 Lynnley Browning, *SOS Unanswered*, N.Y. TIMES, April 2, 2008, at C1.

ing interest rates for a period of five years.[123] Paulson also asked mortgage lenders to ease loan terms for borrowers above the subprime level. He noted that foreclosures were rising even for prime rate mortgages. Although some lenders began to restructure mortgages so that delinquent homeowners would not have to default and go into foreclosure, that process was slow to get off the ground.[124]

It was in the interest of lenders in many instances to make such adjustments because declining housing prices would result, in any event, in a "short" sale that would return less than the amount covered by the mortgage. As a consequence of the continuing decline in the housing market, the number of mortgage adjustments increased. J.P. Morgan Chase & Co. announced at the end of 2008 that it would began a program of modifying mortgages to ease terms for borrowers. It expanded that program in January 2009 to extend to the more than $1 trillion of mortgage loans that it had securitized.[125]

There was much debate in the Bush administration over whether there should be a larger bailout of homeowners who could not meet their mortgage payments. Secretary Paulson objected to such relief, while Sheila Bair, the head of the FDIC was seeking such a rescue.[126] President-elect, Barack Obama announced that he was in favor of providing such relief.[127] True to his word, on February 18, 2009, President Obama announced a $200 billion plan to provide relief for mortgage loan modifications for homes that were under water through Fannie Mae and Freddie Mac. On the same day Freddie Mac completed a $10 billion loan offering, the largest in its history. Another $75 billion was to be used by the Obama Adminisration for private lender loan modification programs. The plan sought to limit loan payments to 31 percent of the borrower's income. Borrowers would be given a $1,000 per year "pay for success" fee for meeting mortgage payments after modification.[128]

There is some precedent for greater government intervention in restructuring mortgages contracts. The farming crisis that occurred during the Great Depression in the 1930s included a massive number of foreclosures on farms and caused much unrest and protests. Congress passed the Frazier-

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123 Edmund L. Andrews and Vikas Bajaj, *Lenders Agree to Freeze Rates on Some Loans*, N.Y. TIMES, (Dec. 6, 2007).

124 *See generally* Edmund L. Andrews, *Relief for Homeowners is Given a Relative Few*, N.Y. TIMES, Mar. 4, 2008) (noting that this process started slowly).

125 Robin Sidel, *J.P. Morgan Expands Loan Effort*, WALL ST. J., Jan. 17, 2009, at B1.

126 Alan S. Blinder, *Missing the Target With $700 Billion*, N.Y. TIMES, Dec. 21, 2007, at BU4 (Paulson was in a "tong war" with Bair over the issue).

127 Edmund L. Andrews, *Treasury Denounced Over Bailout*, N.Y. TIMES, Nov. 19, 2008, at B1.

128 Laura Meckler, *Housing Bailout at $275 Billion—Obama Plan Would Fund Loan Modifications, Cover More Losses at Mortgage Titans*, WALL ST. J., Feb. 19, 2009, at A1.

Lemke Act in 1934[129] in an effort to alleviate some of that suffering. This legislation required appraisals of foreclosed farms in bankruptcy proceedings. The farmer could then seek to have the mortgage holder sell the property at its appraised value under a new six-year mortgage with annual payments set at 2.5 percent of the principal for the first five years, after which payments doubled to 5 percent. Annual interest at a rate of 1 percent was required to be paid on all unpaid balances. If the mortgage holder refused such an arrangement, the bankruptcy court was required to stay all proceedings for five years with the farmer retaining possession of the farm during that period, providing that he paid a reasonable rent. However, the Supreme Court held that that legislation was unconstitutional.[130]

The residential mortgage market was also in crisis during the Great Depression. In an effort to rejuvenate that market, the Home Owners Loan Act of 1933 created the Home Owner's Loan Corp. (HOLC),[131] which was overseen by members of the FHLB. HOLC was funded by a $200 million subscription from the Treasury Department through funds obtained from the Reconstruction Finance Corporation (RFC). HOLC was also authorized to issue its own bonds that were backed by a government guarantee. Initially, that guarantee was only for interest, but not principal payments. However, the guarantee was extended to principal payments as well in 1934 in order to make those bonds more marketable. The eventual amount of bonds authorized for issuance total $4.75 billion.[132]

HOLC was authorized to exchange its bonds for residential mortgages in an amount not to exceed 80 percent of the value of the property. If the lender did not want to accept the bonds, HOLC was authorized to pay cash for up to 40 percent of the value of the property. Single-family residences eligible for this mortgage relief could not be valued at more than $17,500. HOLC was also authorized to advance funds to homeowners who had already lost their homes in foreclosure proceedings so that they might be recovered. Purchases of defaulted mortgages injected new funds into the S&Ls, providing liquidity and allowing them to make new loans and continue their business.[133]

HOLC's mission was to stop the massive foreclosures that were then occurring on home mortgages. It was to achieve that goal by replacing defaulted or troubled mortgages with new mortgages on terms that the home-

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[129] 73 Pub. L. No. 486, 48 Stat. 1289 (1934).

[130] Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555 (1935). The farming crisis was also attacked through a number of crop loan and subsidy arrangements. Jerry W. Markham, II, A Financial History of the United States, From J.P. Morgan to the Institutional Investors (1900-1970), 214-15 (2002).

[131] 73 Pub. L. No. 4348 Stat. 134 (1933).

[132] C. Lowell Harriss, History and Policies of the Home Owners' Loan Corporation 11-12 (1951).

[133] *Id.*

owners could meet. This was accomplished by purchasing the troubled mortgages from banks and then new mortgages were issued to the homeowners on more lenient terms of 15-year maturities at a 5 percent interest rate. HOLC converted the prevalent short-term mortgages into long-term loans that were amortized over the life of the mortgage.[134] This allowed the homeowners to reduce dependence on short-term refinancings and shielded them from a requirement that they make a larger balloon payment only a few years after taking out the loan. Homeowners were able to remain in their homes and build up equity over the years. This loan structure became the model for the "conventional" mortgages that exist even today.

Between 1933 and 1936, HOLC took over more than 1 million home loans.[135] HOLC eventually purchased about 20 percent of all home mortgages during the Great Depression. The total number of loans applied for totaled about 1.9 million with a value of $6.1 billion, which was about half of the outstanding residential real estate debt. Notwithstanding the leniency of the new loans, there was still a 20 percent default rate on the mortgages purchased by HOLC. It ended up owning some 200,000 houses, which were sold over a period of several years. At one point, HOLC held an inventory of over 100,000 homes.[136] When HOLC was disbanded in 1951 it returned $14 million to the Treasury as surplus.[137] Nevertheless, HOLC critics charged that the program did more to help lenders than borrowers.[138] In fact, those efforts actually did little or nothing to restore the mortgage market. Rather, that recovery came with World War II, during which a housing shortage arose.

IX. CONCLUSION

The nation is at a turning point in its history. Many of our leading financial institutions have collapsed or have been effectively nationalized by the federal government. There is even concern that some of those financial institutions will be socialized.[139] This is a most dangerous situation, and every effort must be made to liquidate the government's ownership interest in those institutions as rapidly as possible. Equally important is assuring

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134 Alex J. Pollock, *A 1930s Loan Rescue Lesson*, WASH. POST, Mar. 14, 2008, at A17.

135 C. Lowell Harriss, History and Policies of the Home Owners' Loan Corporation 11-12 (1951).

136 *Id.* at 71-75 (1951).

137 C. LOWELL HARRISS, HISTORY AND POLICIES OF THE HOME OWNERS' LOAN CORPORATION 160 (1951).

138 ROBERT S. MCELVAINE. THE GREAT DEPRESSION, AMERICA (1929-1941) 162 (1961).

139 That socialization is already underway. Bank of America was forced to agree to limits on executive compensation and the government was dictating its dividend and lending policies as conditions for the bank to receive additional cash infusion and troubled asset guarantees telling $135 billion. Louise Story, et al., *Bank of America Posts Loss as it Gets New U.S. Aid,* N.Y. TIMES, Jan. 17, 2009, at A4; U.S. Treasury Dept., Treasury Issues Additional Executive Compensation Rules Under TARP (Jan. 19, 2009), http://www.ustreas.gov/press/releases/hp1364.htm.

that the restructuring of the financial services regulatory system is done in a way that does not unnecessarily impair business or impose unnecessary costs. Certainly, there is a need for regulatory reform, and the Treasury Blueprint provides a useful model. However, at the end of the day, we must recognize that regulation cannot stop business cycles. It can only impair recovery. The financial system will rebuild itself and begin another cycle of prosperity. Unfortunately, that period of prosperity will inevitably lead to another downturn and to another crisis, as has occurred throughout history.

We should also remember that the New Deal regulatory structure that created the federal securities laws and separated the investment banks and commercial banks through the Glass-Steagall Act did nothing to restore the economy during the Great Depression. To the contrary, it inhibited capital investment. It was only the outbreak of war in Europe that saved the economy, not full disclosure or regulation of bank activities.[140] New Deal regulation provided no shelter afterwards. The SEC was incapable of detecting or preventing the Enron era scandals, the subprime crisis or even Bernard Madoff's monstrous $50 billion Ponzi scheme.[141]

In the present environment, there will be much hysteria that will divert attention away from the real causes of the subprime crisis.. Demands are already being made for more SEC style "transparency" regulation.[142] No one seems to know whether or how more transparency will prevent future financial crises. The term transparency is simply tossed out in much the way the terms "organic" and "sustainable" are being used to sell everything from eggs to mattresses. No one seems to really know what those terms mean or what benefits they might bestow on our health or the environment that might justify their higher costs, but we must have them anyway. What the Nation really needs to focus on is the fact that transparency has been mandated since 1933 for the financial services firms that failed during the subprime crisis. Those firms were also exhaustively regulated by the SEC. That transparency and regulation provided no protection from the perfect

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140 For the case against the New Deal see Jim Powell, FDR's Folly, How Roosevelt and His New Deal Prolonged the Great Depression (2003). The Obama administration is facing a monumental task in dealing with the ongoing subprime crisis. It is doubtful that the massive infrastructure building program that he is proposing will be of any benefit to restoring the economy. That same action was tried in the Great Depression and failed.

141 The SEC had been alerted several times that there might be something amiss in Madoff's operations. Alex Berenson, *'92 Ponzi Case Missed Signals About Madoff*, N.Y. TIMES, Jan. 17, 2009, at A1. SEC Chairman Christopher Cox subsequently expressed concern over his agency's handling of this affair. He found "deeply troubling" that the SEC had "credible and specific warnings" of the Ponzi scheme for some time. Stephen Labaton, *S.E.C. Knew Him as Foe and Friend*, N.Y. TIMES, Dec. 18, 2009, at B1.

142 *See, e.g.*, Robert M. Morgenthau, *Too Much Money Is Beyond Legal Reach*, WALL ST. J., Sept. 30, 2008, at A19. ("A major factor in the current financial crisis is the lack of transparency in the activities of the principal players in the financial markets.").

storm that arose during the subprime crisis and will shield no one from the next one.[143]

[143] In apparent recognition of the past failure of "transparency" regulations, reformers are now demanding "true" transparency. Bill Bradley, Five Ways to Restore Financial Trust, WALL ST. J., Feb. 19, 2009, at A19. Yet, SEC regulations already require "full" disclosure. Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 151 (1972). Existing SEC regulations also prohibit untrue transparency and require disclosure of every "material" fact. 17 C.F.R. §240.10b-5.