Introduction

Thirty years of substantial deregulation based largely on neoliberal free market philosophies unleashed a regime of finance capitalism in America. Many American industrial corporations began to increase their reliance on debt in the 1980s. By the 1990s, commercial and investment banks had turned the invention of new financial derivatives into a major business, and generated huge profits from dealing and trading in them. They also discovered that profits from derivatives rose considerably as the instruments and underlying assets were increasingly leveraged. The mantra of ‘risk management’ provided a tempting rationale for speculation that often assumed reckless dimensions. The American economy reached a point toward which it had aimed for a century – the dominance of finance over industry, as many of the best minds from the academy and the most talented from business were drawn to Wall Street.

As early as the 1950s, insightful thinkers like Peter Drucker predicted a shift in the American economy from manufacturing to service. Less clearly anticipated was a more dramatic, and ultimately more significant, transformation from production to finance. The prolonged (if inconstant) bull market that began in the 1980s and resumed after the 1987 market crash made this shift look both inevitable and infinitely sustainable. By the late 1990s, there was widespread acceptance of the view that a new era in finance had come, that the old rules no longer applied and that virtually limitless wealth was available to those who invested in old and new forms of securities and relied on the inexhaustible ingenuity of American enterprise. After all, hadn’t old Junius Morgan himself instructed his son never to sell America short? A new era was at hand.

The phrase ‘New Era’ was used both at the turn of the twentieth century and in the late 1920s to describe the apparent repeal of the business cycle. The financial and economic ends of both exuberant eras were devastating. Yet the federal government at the turn of the twenty-first century serially dismantled many of the most important protections that resulted from the sad learning of the earlier period. Perhaps most significantly, the venerable Glass-Steagall Act, which from its enactment in 1933 had helped to prevent the kind of systemic banking panics that had repeatedly occurred in America during the previous century, was repealed. In
The panic of 2008

the Gramm-Leach-Bliley Act of 1999 (GLBA), the federal government for the first time gave its explicit blessing to the nation’s most significant financial institutions – those responsible for sustaining and protecting credit supply and systemic financial integrity – to speculate in securities. Commercial banks blended with investment banks and the resulting ‘universal banks’, together with the remaining securities firms, increasingly leveraged their equity to generate higher profits. A compliant Securities and Exchange Commission, charged with ensuring the safety of American securities markets, stood back in the face of apparently increasing prosperity and, perhaps, based on some degree of misplaced faith in the integrity of market actors.

The bursting of the dot.com bubble in the earliest years of the twenty-first century did little to dampen spirited speculation. Instead, the Federal Reserve’s accommodating monetary policy helped to spread the fever from stock markets to housing markets. A housing boom empowered homeowners to finance record levels of consumption by borrowing against the illusory growth in home values. Rising consumption produced a sharp increase in corporate earnings. Analysts, traders, and investors celebrated record corporate profits while failing to see that, during the preceding three decades, internal equity had fallen sharply and had been replaced by debt. A new wave of leveraged buyouts swept through the economy as private equity firms repeated, with new variations, the takeover strategies Michael Milken pioneered during the 1980s. To protect themselves against such buyouts, incumbent managers borrowed heavily to ‘enhance shareholder value’, either by engaging in debt-laden internal restructurings to return capital to shareholders or by financing large share buybacks. The overleveraging of American industry proceeded in tandem with overleveraging of American housing. The proliferation of complex derivatives and a dramatic increase in off-balance sheet financing helped to mask the truth. American industrial corporations, financial institutions, and investors assumed, and exposed the American economy to, dangerous levels of credit risk, liquidity risk and market risk.

The triumph of the financial sector in America inspired imitators in the United Kingdom and Europe. UK and European universal banks followed similar strategies of underwriting speculative securities, dealing in complex derivatives, and promoting housing booms. As in the US, housing bubbles in UK and European markets were inflated by dramatic increases in housing prices and reckless extensions of mortgage credit to borrowers who could not afford to pay for homes they had purchased. In the United States, mortgage lending reached unprecedented levels, thanks to the willingness of mortgage lenders to create subprime and ‘Alt-A’ mortgages with low initial borrowing costs, as well as the Federal Reserve’s policy
of maintaining historically low interest rates. Mortgage originators sold
these risky mortgages to universal banks and investment banks, which
repackaged them into mortgage-backed securities and collateralized debt
obligations. Credit rating agencies gave their stamp of approval, and the
volume of mortgage-related securities skyrocketed along with the steady
rise in housing prices.

After reaching record highs, housing prices stopped rising in 2006
and began to decline sharply in 2007, as interest rates edged upwards
and monthly payments on subprime loans increased according to their
contractual terms. With the puncturing of the housing bubble, investors
became concerned about the security of any investments related to the
housing market. In a manner eerily reminiscent of the Panic of 1907, gradu-
ally increasing fear among financial institutions and investors created
disturbances in American and international credit markets during the
late summer and early autumn of 2007. The Federal Reserve and its UK
and European central bank counterparts responded by injecting liquidity
into the financial markets, but their efforts proved ephemeral. Liquidity
in interbank lending markets evaporated, major financial institutions
reported large losses, and securitization markets shut down.

Stronger financial institutions acquired weaker ones beginning in March
2008, when JP Morgan Chase announced its fire-sale acquisition of one of
the world’s storied investment banks, Bear Stearns. The deal, supported
by the Federal Reserve Board and Treasury Department and backed
by government financial guarantees, recalled John Pierpont Morgan’s
famous rescue of the Trust Company of America during the Panic of 1907.
A brief period of calm ensued during the early summer of 2008, and then
the American economy appeared to tear apart at the seams.

During the late summer and fall of 2008, the following massive
firms, from every major sector of the financial services industry, either
failed, were merged into stronger competitors with federal assistance, or
were seized and placed under federal oversight: (1) investment banking:
Lehman Brothers and Merrill Lynch; (2) commercial banking: IndyMac,
Wachovia and Washington Mutual; (3) insurance: American International
Group; (4) mortgage finance: Countrywide, Fannie Mae and Freddie Mac.
Despite $90 billion of capital support and $400 billion of asset guarantees
provided by the federal government, two giants of commercial banking,
Bank of America and Citigroup, were severely damaged and were obliged
to accept close oversight by federal regulators. In addition, the last two
titans of investment banking, Goldman Sachs and Morgan Stanley, were
forced to convert from investment banks into bank holding companies.

Confronted with an imminent collapse of the stock market, Congress
approved a $700 billion Troubled Assets Relief Program (TARP), urged
by Treasury Secretary Henry Paulson as a tool to enable government buy-outs of devalued derivative securities. The program’s limited early successes led the Treasury Secretary quickly to shift TARP’s purpose extensively into a program of government debt and equity financing for a cascade of failing financial institutions numbering in the hundreds or thousands. In a demonstration of the financial crisis’ far-reaching impact on the real economy, the Bush administration also opted to use TARP funds to provide capital to the country’s automotive manufacturing sector, lending $14 billion to Chrysler and General Motors (GM) to avert their immediate bankruptcies.

Despite unprecedented federal government financial intervention, the nation’s economy collapsed into the worst recession since the Great Depression of the 1930s. Many analysts argued that ‘depression’ was a more accurate description of the US economy in early 2009. The Obama administration took office and quickly persuaded Congress to approve an $800 billion stimulus package. The new administration also engineered comprehensive restructurings of Chrysler and GM through accelerated bankruptcy proceedings that required $40 billion of additional financing from the federal government. However, despite occasional signs and pronouncements of the beginning of a much-anticipated recovery, the US economy continued to languish in the summer and autumn of 2009. Many corporations that previously relied heavily on debt financing no longer had sufficient internal equity or external financing to sustain their operations. The national unemployment rate rose to nearly 10 per cent, a level not seen since the early 1970s, and home foreclosures reached levels unmatched since the 1930s. The long-term consequences of the financial crisis for the American economy remained uncertain in late 2009, as large-scale defaults on commercial real estate loans and other corporate obligations loomed on the horizon.

Since the beginning of the financial crisis in August 2007, investment professionals, participants in the financial services industry, policymakers, members of Congress, academics, and the media have sought to identify and understand the causes of the crisis, assess its continuing extent, and develop ways both to clean up the fallout and to prevent future panics or at least mitigate their magnitude. It was in this environment, and to meet this need, that a conference entitled ‘The Panic of 2008: Causes, Consequences and Proposals for Reform’ – upon which this volume is based – was held at The George Washington University Law School on April 3–4, 2009.

The following speakers presented their views on various aspect of the panic at the conference: Robert Ahdieh, Edward Altman, Dennis Berman, William W. Bratton, Robert Bruner, Sean Carr, Rodgin Cohen, James D. Cox, Rob Cox, Lawrence A. Cunningham, Jesse Eisenger, Lisa M. Fairfax,

The chapters in this volume, a subset of the papers presented at the conference, cover a wide range of issues and both explain and, in their diversity, illustrate, the extent of the crisis. The first part of the book turns to history in order to situate this particular economic collapse within the broader scope of what Charles Kindleberger, in his classic book, describes as manias, panics, and crashes. Maury Klein leads off with a wonderful piece of historiography, explaining how history can and cannot help us understand what happened. Unfortunately, history is limited in its ability to guide us because, as Klein observes, life is messy and people are messy. So while historical patterns may exist, based on evidently enduring human impulses and imperfections, passions and predilections, the lessons of one panic will never fully explain the causes of another crisis, still less enable us to solve it or prevent it. Simply put, context matters, and the social, economic, regulatory and political context of the current decade is so different from, for example, the context of the late 1920s, that despite the obvious parallels, the differences are equally compelling.

As important, no serious historian can tell us very much about the causes and consequences of the panic of 2008 because it remains an ongoing event. Just as Klein points out that historians continue to disagree about the causes of the 1929 crash and the Great Depression, contemporary thinkers have only begun to explore the surface of the problems that brought on the current crisis, even as they live through it and try to cope with its fallout. Time alone will tell how similar or different this panic is to others of the past, whether the current great recession will mimic the patterns of the Great Depression, or whether the distinctive features of the present crisis will require us to classify it as an entirely different kind of economic event. Nonetheless, Klein deftly provides us with a fascinating comparative overview of the two most significant US financial crises in living memory.

Ken Snowden’s chapter explores a critically important aspect of the possible historical analogy between the Great Depression and our contemporary
situation: namely, the residential mortgage crisis of the 1930s. As he
describes it, the crisis and its long-term effects originated in a series of four
major events; (i) the dramatic growth of residential mortgage debt in the
1920s, facilitated by high leverage, easy credit, the innovation of private
mortgage insurance, and securitization of some mortgages; (ii) the liquida-
tion during the 1930s of many of the financial intermediaries that had created
the financial innovations that stimulated the mortgage boom; (iii) federally-
backed efforts to strengthen portfolio lenders (including commercial banks,
life insurance companies, savings & loan associations (S&Ls), which grew
out of the failed building & loan associations (B&Ls), and mutual savings
banks); (iv) the federal government’s creation of the Home Owners Loan
Corporation, a ‘bad bank’ designed to purchase defaulted mortgages; (v)
regulatory changes that created a dominant position for portfolio lenders;
and (vi) the success of the Federal Housing Authority’s loan program com-
bined with the failure of efforts to create a government-sponsored program
for securitizing mortgages. The failure of securitization in the 1930s shaped
the residential mortgage market for the next 40 years.

The New Deal’s transformation of mortgage lending produced an insti-
tutionalization of the residential mortgage business. Snowden notes that
in the 1920s, more than 40 per cent of residential mortgages were held by
individual investors in a population that consisted primarily of renters.
Mortgages were made conservatively, typically for no more than the value
of the property, and ran for what by modern standards were very short
terms. But while financial institutions were the minority of lenders, they
grew rapidly in significance during the 1920s. B&Ls expanded aggres-
sively, as residential builders used them to finance new housing projects.
Institutional lenders began to offer second mortgages as a way to provide
higher loan-to-value mortgage financing. At the same time, individual
mortgage investors found ways to diversify their investments and obtain
liquidity by participating in the new methods of securitization offered by
mortgage guaranty companies and real estate bond houses. Mortgage
guaranty companies also began to offer private mortgage insurance and
participation certificates on mortgage collateral.

Due to the massive increase in housing credit and homeowner indebted-
ness produced by these innovations, crisis was at hand. Defaults began
to reach alarming rates in the late 1920s and continued throughout most
of the 1930s, affecting primarily the lightly-regulated B&Ls, thousands
of which were liquidated in the early and mid-1930s. Mortgage guaranty
companies, which were more closely regulated, initially escaped that fate
despite financial difficulty, although significant liquidations were to occur
by 1933. Approximately 80 per cent of real estate bonds, issued by unregu-
lated bond houses, were in default in 1935.
Snowden describes the regulatory responses of the Hoover and Roosevelt administrations, in which the federal government allowed many B&Ls, mortgage guaranty companies, and real estate bond houses to fail, while working to save most of the commercial banks and insurance companies, as well as a subset of the B&Ls which were the most professionally and soundly managed and which eventually came under the auspices of the newly-created Federal Home Loan Bank Board. Mortgage relief to homeowners was provided by the Home Owner’s Loan Corporation, which, as Snowden describes, was a ‘publicly-financed “bad bank” for home mortgage lenders’. The emergency New Deal measures attained greater permanence after the immediate crisis was addressed. Many B&Ls converted to regulated S&Ls, and the Federal Savings and Loan Insurance Corporation, created in 1934, provided new measures of financial security, including a deposit insurance scheme for S&Ls. The National Housing Act of that year also authorized the creation of Fannie Mae and Freddie Mac to buy and sell Federal Housing Administration loans from the local mortgage companies that originated them.

Snowden concludes with a discussion of the system of residential mortgage lending that was created by the New Deal’s reforms. Portfolio lenders dominated the mortgage industry for four decades, backed by federal regulation and deposit insurance. However, the stability of portfolio lenders was ultimately destroyed by the great inflation of the 1970s and early 1980s. After portfolio lenders failed or abandoned the mortgage lending business, a new form of mortgage securitization arose. In turn, the new securitization scheme helped to sow the seeds of the present crisis.

Part II of the book addresses the causes of the panic and proposals for reform. We begin with James Fanto’s analysis of how misguided risk management practices contributed to the crisis. Risk management is designed to assess and monitor the risks a financial institution undertakes, assure the availability of resources to deal with them, provide adequate risk information to senior managers, and to devise ways of dealing with risk. Risk management has increasingly come to rely on quantitative financial modeling. However, as Fanto explains, stress testing (which assesses the strength of an institution to meet financial adversity) and scenario analysis (which analyzes the ways in which adverse events might occur and the consequences if they do) also remain centrally important components of risk analysis. It is these latter components of risk analysis – stress testing and scenario analysis – that Fanto claims failed in the face of the oncoming crisis.

The risks incurred by a financial institution determine the amount of capital that the institution must hold to protect itself from failure. Not surprisingly, minimum capital requirements have long been an important
feature of financial regulation. Changes in the business models of financial institutions, facilitated by the enactment of GLBA in 1999, led traditional lending institutions increasingly to engage in securities trading and other capital markets activities. Thus, one of the first changes in risk management Fanto describes is a regulatory shift from capital requirements based primarily upon credit risk – namely, the risk of default in a financial institution’s loan portfolio – to capital requirements based on market risks inherent in the lines of business engaged in by the institution, including interest rate risk and systematic risk from general market conditions. As financial professionals developed their own quantitative risk models for pricing securities, regulators agreed to a form of quasi-self-regulation, in which regulators permitted financial institutions to use their own internal risk models as long as they complied with certain conditions.

Fanto focuses primarily on two adjuncts to risk assessment based on quantitative models – namely, stress testing and scenario analysis. Stress testing and scenario analysis are financial analogues to military contingency planning. While quantitative in part, these forms of risk management also involve significant qualitative factors and are grounded in human judgment as much as they are in mathematics. Stress testing and scenario analysis take into account not only the cultures and businesses of specific financial institutions but also their interrelatedness with other participants in the market, as well as risk managers’ assessment of the anticipated behavior of other financial institutions. The quality and reliability of an institution’s stress testing and scenario analysis are factors evaluated by regulators in determining capital requirements.

Despite the importance of stress testing and scenario analysis for anticipating and responding to a financial crisis, Fanto argues that these methods of risk management failed, and that their failure was a significant contributing cause of the crisis. Financial institutions relied too heavily on quantitative analysis, which typically assumed a very low probability of serious adversity. To the extent such analysis was performed, it was not done well. Risk managers, perhaps made unduly confident by superior recent performance, failed to take a long view of a financial history peppered with crises and did not plan accordingly. Moreover, risk management typically occurred at a divisional level, and there was a noted failure to aggregate the separate results into a firm-wide risk profile. Risk managers failed to consider the interrelatedness of different sectors of the financial system and the possibility that failure in one segment might infect others, or financial markets more generally. Senior managers and boards were unduly complacent. And regulators were insufficiently rigorous in demanding that financial firms use adequately adverse scenarios in their evaluations.
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Based on these failures, Fanto calls for a thorough reform of the stress testing and scenario analysis procedures. Notwithstanding the good sense of his proposals, he recognizes that serious obstacles exist to implementing them, not the least of which are the extraordinary complexity of business lines and relationships both within and among financial institutions. This complexity poses a danger that managers will be lulled into a false sense of security by reassuring results from stress tests that are incapable of fully capturing an institution’s risk. It is also reasonable to expect that managers will not fully act on even reliable risk assessments because of the human tendency to underestimate the risk of loss and the unwillingness of profit-oriented executives to manage an institution based on concerns about worst-case outcomes. Fanto concludes with a plan of action to more forcefully address these problems and ensure that risk management properly serves its critical functions.

Steven Schwarcz’s chapter moves us from financial institutions to financial markets. He reconceives the financial regulatory safety net to address modern conditions, moving from the moral hazard of protecting financial institutions that have grown too big to fail to broader protection of financial markets which have become the dominant suppliers of credit within developed economies. Schwarcz importantly begins with a recognition that has been all-too absent in contemporary regulatory debates – namely, the reliance of the real economy on funding from the capital markets in order to produce the essential goods and services and the acquisition by consumers of houses and durable goods on which we rely. Treating the panic as a market story rather than a banking story, Schwarcz’s focus reflects Willie Sutton’s answer as to why he robbed banks; that’s where the money is. And, in Schwarcz’s view, it is important to recognize and protect the transformation from bank-based finance to market-based finance because disintermediation – the process of moving the funding of enterprises from financial intermediaries to capital markets – has the potential to increase financial efficiency significantly.

Schwarcz contends that the efficiency of securitization enables borrowers to obtain capital from capital markets more cheaply than from financial intermediaries whose own administrative costs, capital requirements, and costly acquisition of information are reflected in their credit pricing. Securitization also permits institutional loans to be packaged and sold in return for additional cash to be loaned for real economic purposes. Schwarcz acknowledges the moral hazard created by the originate-to-distribute model of securitized lending that developed in the years preceding the crisis, the conflicts of interest in servicing, and the potential (and, in the current crisis, realized) problems created by unjustified reliance on quantitative risk modeling. Nevertheless, Schwarcz believes that the
potential benefits of securitization are sufficient to outweigh its potential risks. Indeed, Schwarcz tells us that although the abuses created by securitization of mortgages and its related products, like ABS CDOs, may have precipitated the crisis, ‘securitization can also help get us out of it’.

While Schwarcz has elsewhere proposed prescriptive regulation to help prevent systemic financial crises, he acknowledges that market developments can easily outpace regulation. As a consequence, he proposes the development of a regulatory facility that can serve as a safety net when regulation fails, a facility that he calls ‘a market liquidity provider of last resort’. Schwarcz contends that a liquidity provider of last resort should perform for financial markets a service similar to that which the Federal Reserve’s discount window provides to banks. While such a facility would not be expected to function in normal markets, it would intervene to prevent a market disruption from degenerating into a full-blown crisis in which panicked investors produced a generalized collapse of prices by continuing to sell assets into falling markets.

The liquidity provider could stabilize markets by purchasing securities at prices that reflect deep discounts, both from their recent market prices and also from their intrinsic values, but are higher than an anticipated panic-induced level. Alternatively, the liquidity provider could provide hedging for the falling securities. Among other advantages of such a system, Schwarcz suggests that the liquidity provider would address the too-big-to-fail problem because its purchases or hedging would protect large financial institutions whose solvency might otherwise be threatened by a market collapse.

Schwarcz shows how such a liquidity provider might have acted in the current crisis, comparing the actual relief efforts provided by government authorities to the assistance that a liquidity provider of last resort might provide. He then goes on to address practical issues, as well as to extend his vision to international markets to show how his proposed liquidity facility might help to prevent the globalization of a financial catastrophe, or at least to mitigate its effects.

Financial markets, especially the credit markets, have long relied upon the rating agencies to ensure the marketability of bonds and other debt securities, among other instruments. Frank Partnoy lays much of the blame for the crisis directly at the feet of the ratings agencies, and argues that both regulators and investors should substantially lessen their dependence on those agencies in order to prevent another crisis.

Ratings agencies arose as a means of correcting information asymmetries between sellers of securities, which possess information that is difficult and costly to convey credibly, and investors. As Partnoy explains, credit rating agencies fulfilled this informational intermediary role from
their creation in the nineteenth century until the mid-1970s, a time when the SEC began relying upon the agencies for regulatory purposes and also when the agencies shifted from an ‘investor pays’ business model to one in which the issuer paid the agency in order for their securities to be rated. In Partnoy’s felicitous phrasing, ratings agencies changed from informational intermediaries to sellers of ‘regulatory licenses’. As financial innovation proceeded and the earliest forms of CDOs were created, issuers consulted with ratings agencies in order to structure deals in ways that would achieve the desired ratings, and the agencies were happy to collect handsome fees for their consulting work. Partnoy tells the story of how the combination of the ‘issuer pays’ business model and the proliferation of new types of structured rated securities led to significant downgrades in the quality of ratings analysis, as illustrated by the 1994–1995 bond market crisis.

Partnoy’s cogent tale of the move from first level to second level securitizations, which took advantage of the apparent mispricing of highly-rated mortgage-backed securities, inexorably leads us deeper into the complexity and deceit of the recent credit bubble, in which the ratings agencies were prime players. Synthetic CDOs and SIVs depended for their marketability on their credit ratings. Even if investors had wanted to examine the underlying assets, those assets were frequently unidentifiable and subject to rapid and unpredictable turnover based on banker-determined investment parameters. Credit rating agencies willingly acquiesced in providing high ratings for complex tranches of opaque CDOs, using risk models that relied on outdated assumptions and other flawed inputs to produce the desired results.

In the absence of overreliance by regulators and investors on the rating agencies, Partnoy suggests that the crisis might not have occurred because the toxic financial instruments that precipitated the crisis could not have been marketed and sold. Accordingly, one solution is to combat this overreliance. How is this to be done? Partnoy suggests that regulators should cease to rely on credit ratings. Regulatory reliance is not only a problem in the US. As he points out, the Basel II capital accord drafted by the Basel Committee on Banking Supervision allows banks to use credit ratings to determine their net capital requirements. Partnoy’s recommendation is to substitute market-based risk measures for credit ratings. He also suggests the administration of ‘shock therapy’ to investors to wean them from over-reliance on ratings agencies. He particularly notes the differences in meaning between ratings on corporate bonds and those on exotic structured financial instruments such as CDOs and SIVs, which require far deeper and more nuanced analysis than the ratings agencies provided during the past decade. Improved disclosure to investors by issuers is also important. Partnoy concludes with a discussion of how market measures
and asset prices can facilitate better risk analysis than can the ratings agencies.

Thus, in explaining the causes of the financial crisis, Fanto tells a story of failed risk management, Schwarz offers a tale of dysfunctional capital markets, and Partnoy provides an account of over reliance by government officials and private investors on highly conflicted ratings agencies. For her part, Patricia McCoy tells a story of regulatory competition and agency capture to support her conclusion that effective consumer financial protection is urgently needed to protect our economy from a repetition of the widespread predatory lending that helped to promote the housing bubble and ultimately led to massive defaults on subprime and Alt-A mortgages.

The dispersal of lending regulation within the federal government and among states created a fragmentation in which lenders were able to choose the most lax regulatory regime, regulators became compliant because of the competition among regulators for business, and bank profitability rather than consumer protection became the primary goal of regulatory agencies.

In terms of contributing to the crisis, the high degree of dispersion among lenders produced results contrary to what one would expect in an industry characterized by vigorous competition. Instead of reducing their prices to consumers, mortgage lenders increased their market share by introducing new and risky products that were superficially attractive to borrowers who were not equipped to assess the risks of such products. Loan-to-value ratios increased and banks relaxed their underwriting standards in order to generate higher volumes of mortgages for securitization. The riskiest borrowers turned to, and were readily granted, the riskiest loans. Moreover, the riskiest loans were concentrated in regions with expensive housing markets. The availability of mortgage credit expanded with the influx of new financing from Wall Street investment banks, causing housing markets to become sellers’ markets in many areas. Consequently, home prices rose to unsustainable levels.

Low interest rates following the 2001 recession started the housing bubble, but as interest rates began to rise and demand for prime mortgages fell, lenders responded by creating new types of subprime mortgage products with introductory ‘teaser rates’ that made borrowing seem initially affordable to those priced out of the prime mortgage market. However, the longer-term costs of subprime mortgages, and thus their true risks to borrowers, were masked by complex terms, the difficulty of obtaining loan commitments early enough to allow borrowers to comparison shop, and the hidden yield spread in commissions paid to mortgage brokers. The perverse dynamics of the subprime mortgage market, McCoy reports, made ‘informed consumer choice impossible’.
Lenders’ ability to hide risks in the fine print allowed the purveyors of these dangerous mortgage products to win market share from traditional lenders offering 30-year, fixed-rate prime loans. Federal regulators allowed this to happen. Federal regulators failed to exercise their powers to ensure the safety of loan products and enforce regulations against lenders that ignored them. In addition, regulators failed to prevent banks from investing in risky mortgage-backed securities and CDOs, and they allowed banks both to hold dangerously risky assets on their balance sheets and to ‘park’ such assets in off-balance-sheet conduits the banks sponsored. The core cause of all of this hazardous behavior, McCoy tells us, was fragmented regulation, and she explains in detail the nature and consequences of that fragmentation.

Notwithstanding the problem of supervisory fragmentation, regulatory control could still have been asserted. The Federal Reserve Board (FRB) could have prohibited toxic mortgages by adopting comprehensive federal anti-predatory lending rules. Largely because of former FRB Chairman Alan Greenspan’s commitment to deregulation, the FRB failed to adopt such rules, leaving the market at best under-regulated and, at worst, unregulated entirely. Interestingly, McCoy points out, state regulators began to act more aggressively under their own consumer protection legislation than did federal regulators. But this was of no avail in the case of national banks and federal savings associations, because those institutions – which included many of the largest originators and funders of subprime and Alt-A mortgages – were shielded from state law by preemptive regulations adopted by their regulators. The Office of Thrift Supervision (OTS) and the Office of the Comptroller of the Currency (OCC) had ample financial incentives to adopt preemptive rules to immunize their regulated constituents from state regulation, because both agencies depended on fees paid by their constituents to fund their budgets. Granting preemptive immunity discouraged lending institutions from defecting to other federal regulatory regimes, and also had the potential to persuade state-chartered lenders to shift to federal charters.

Federal regulators could have, but failed to, tighten their regulation and enforcement. Instead, as McCoy puts it, ‘federally regulated lenders – as well as all lenders operating in states with weak regulation – were given carte blanche to loosen their lending standards free from meaningful regulatory intervention’.

The results of such regulatory failure are now painfully obvious, and McCoy highlights the ‘inextricable’ link between consumer protection and systemic stability. Her solution, which as of her writing is consistent with the Obama administration’s proposals, is to (i) adopt federal uniform consumer protection standards for all consumer financial service providers;
(ii) vest the authority to administer and enforce these laws in one federal agency created for the purpose of consumer protection, (iii) allow states to adopt supplemental consumer protection laws; and (iv) provide ‘parallel enforcement authority to federal banking regulators and the states and allow consumers to bring private causes of action to recover for injuries they sustain’. McCoy concludes by evaluating the Obama administration’s plan in light of her analysis, and she supports the plan’s proposal for a unified and independent federal consumer protection agency with authority to regulate federally-chartered and state-chartered providers of financial products.

William Handorf, approaching the problem from the perspectives of a banker, a bank regulator and an academic, sees plenty of blame to go around, but he understands the crisis as resulting largely from regulatory failures. Unfortunately, he sees little evidence in the regulatory responses to the current crisis to give us comfort that we can prevent future systemic failures, noting that banking panics occur roughly every 15 years. The nations of origin and particular catalysts may change, but the pattern of financial crisis remains roughly the same, arising out of inadequate bank capital, inadequate liquidity reserves, inappropriate pricing, risky investment, concentrations of risk, reckless origination of loans, and aggressive distribution of investment products in order to produce fees and promote a rapid growth of bank profits. The economic environment also is important, particularly when widespread bank failures accompany a recession or, as in the current crisis, precipitate a recession, which increases bank losses by causing defaults by borrowers and depriving consumers and businesses of necessary credit. Finally, failure occurs because bank management becomes complacent, failing to identify and properly monitor and control risk. As Handorf notes, these factors all correlate with lax monitoring and enforcement of prudential requirements by regulators. Additional factors, present in the current crisis, include overleveraging and bank reliance on less-expensive, short-term funding to increase return on assets (thereby increasing bank liquidity risk), and investing in poor quality assets.

Handorf moves quickly from the causes of the present crisis to the lessons to be drawn from it, which nicely summarize the arguments of the previous chapters. Handorf’s lessons include (i) the Federal Reserve’s maintenance of interest rates that were too low for too long, thereby encouraging speculation with cheap money, (ii) managerial inattention to risk management, and (iii) regulatory failures to assert control over dangerous consumer loan products. In addition, as Hahndorf puts it, ‘credit rating agencies failed miserably’, and investment banks pursued an ‘originate-to-distribute’ business strategy, which reduced due diligence
and created conflicts of interest at each step of the lending and securitization process. Meanwhile, the predominance of unregulated loan brokers helped to promote a nationwide proliferation of toxic mortgage products, and the federal government pushed too hard to expand homeownership by encouraging the extension of credit to borrowers who simply could not afford to pay the mortgages on their homes.

His clear insights into the causes of the current crisis lead Hahndorf to conclude on a pessimistic note: 'Unfortunately, history suggests similar problems discussed in this conference will resurface in approximately 15 years.'

The consequences of the credit crisis are all too graphically presented by Edward Altman. Surveying the wreckage in the high-yield bond market, Altman’s study shows that distressed and defaulted high-yield debt rose to $3.59 trillion in 2008 from only $867 billion a year earlier. Although Altman’s default rate forecast of 4.64 per cent was slightly higher than the actual default rate of 4.60 per cent in 2008, the predictions for 2009 are horrifying, with a consensus average rate of 13.63 per cent (and a range of 7.98 per cent to 18.23 per cent). The first quarter of 2009 was well on target to achieve this result. The average recovery rate on defaulted high-yield debt in 2008 was only 42.5 per cent, and Altman’s projections indicate that the average recovery rate will fall to 24 per cent or less in 2009. These data are just the tip of the iceberg. Altman presents his characteristically thorough and detailed analysis of a junk bond market that has yet to show any significant recovery from the financial crisis, and can be characterized as little short of devastated. Indeed, Altman predicts that ‘[w]ith the current recession likely to continue through the entirety of 2009 (or beyond), it is quite likely that the high-yield default rate will continue to rise in 2009, and possibly in 2010’.

Although many of the preceding chapters conclude with reform suggestions, the remaining chapters move more directly to reform than diagnosis. Tamar Frankel’s interesting chapter considers the way we think about regulating our financial markets. As she notes, we traditionally engage in two core forms of regulation; disclosure by issuers of essential financial and business information, and self-regulation by financial intermediaries, all based on the underlying policies of monitoring the costs and benefits of regulation, protecting financial innovation, and enforcing the law after it is broken (in contrast to rigorous ex ante monitoring).

The existing regulatory structure clearly failed to prevent the present crisis. While Frankel continues to support mandatory disclosure, her core answer to the question of how we prevent future crises is that we should set up regulatory mechanisms that monitor markets continuously in order to detect bubbles. As Frankel aptly puts it, market regulators should perform
examination functions similar to those of bank regulators, paying special attention to the largest institutions and those that have received regulatory exemption. But Frankel is cautious; this kind of continuous monitoring has the potential to chill financial innovation. Therefore, the new market regulators should not be charged with altering the economic incentives of those forces that appear to be driving prices to bubble levels but rather should be limited to detecting and prosecuting legal violations, as well as addressing behavior that, while not technically illegal, appears to violate the ‘spirit of the law’. While admittedly an expensive way to regulate, Frankel believes that the cost of enhanced monitoring by financial regulators is undoubtedly far less than the costs imposed on the economic system and society by market crashes and panics.

Frankel makes the important point that the intensity of regulation by examination should be countercyclical rather than the procyclical regulation that characterized oversight prior to the panic. In other words, regulation should be more intensive when times appear to be good rather than bad. For it is in the good times, the frothy, bubbly times, that fraud and illegality are most likely to flourish and are most difficult to detect. Naturally, the most intensive examinations should be performed on the largest, most highly leveraged, institutions, as well as those who have received legal exemptions, and regulators should be especially suspicious of those whose share prices appear to rise steadily and without significant fluctuations. Frankel closes with an evaluation of other, failed, regulatory approaches, and concludes that the bank regulatory model is likely best to serve us in protecting economic and financial stability.

Theresa Gabaldon tells a sad tale of collateral damage that teaches important lessons for reformers while explaining that one of the most significant forms of damage created by the crisis is lost trust. And she trenchantly tells the tale in the form of a case study involving the sewer bonds of Jefferson County, Alabama.

Finance is inherently about what will happen in the future. That is, of course, no reason to disregard the lessons of the past. Gabaldon plumbs a single, but impressive, failure of modern finance, the sewer bonds issued by Jefferson County. This story provides an opportunity to examine how the subprime mortgage crisis roiled the waters of finance, swamping with debt service issuers of securities that had nothing to do with subprime lending. As a morality tale, that same story unhappily cautions against trust at the same time that it teaches that trust of a sort is an inevitable precondition for modern finance.

One of the most important lessons of the Jefferson County sewer debacle is that disclosure, as presently practiced, is plainly inadequate as a method of avoiding financial harm. For instance, Gabaldon’s examination of the
actual prospectuses used in connection with the Jefferson County debacle demonstrates that, in complicated financings, the wrong entities are called upon to make public disclosures. Even with revamping, however, she concludes that disclosure is unlikely to provide the protection that many of the participants in modern securities markets arguably need. In some instances, it appears that the only realistic course of action for those participants is to resort to trust.

Trust, however, can be neither justified nor sustained without significant attention to its conditions. Those conditions include both the intentions and the abilities of trusted actors to perform. Although the law has at least some capability to deal with problems of intention, it deals awkwardly, at best, with problems presented by a lack of ability to perform one’s commitments. Gabaldon’s solution is to buttress the conditions of trust with a full-cry demand that certain actors ‘speak the truth’ or suffer significant legal consequences. Although this appears to circle back to a requirement of full disclosure, the ‘duty of truth’ is different, because it calls upon an actor to be right and not just forthcoming. Thus, Gabaldon argues, the statements of actors critical to financial systems should be required, in the rearview mirror, to be completely correct on what effectively is a strict liability basis.

Trust has been breached in another way as well. Long before the crisis, executive compensation had become a major issue of public and scholarly debate. While some analysts question the extent to which the dramatic rise in executive compensation in recent years, especially in the financial industry, had much to do with the causes of the panic, others see a direct link. At the very least, there appears to be general revulsion at the continuation of extraordinary bonuses paid by financial institutions that were leading participants in the crisis and also received federal bailout money, not the least of which include AIG, Goldman Sachs, and JP Morgan Chase, the latter two of whom reported record profits and plans for large bonus payments in the third quarter of 2009, even as the crisis continued.

Edward Labaton and Michael Stocker see executive compensation and its metastatic growth as clearly playing some role in the reckless assumption of leverage and risk that led to the panic. Even if that role is indirect, we agree that the atmosphere created by excessive executive compensation leads both to short-term performance incentives and a concomitant willingness of top executives either to ignore excessive risk or affirmatively to embrace it.

A major problem in restraining executive compensation, which at least for the moment remains largely an issue of state law, lies in legal restrictions on the ability of plaintiff shareholders to bring derivative litigation on behalf of their corporation. As Labaton and Stocker nicely illustrate,
the rules requiring shareholder demand on the company’s board of directors, and the concomitant principles governing demand excusal or futility, have effectively shut most shareholders out of the possibility of getting past the dismissal stage of a derivative suit, making the process of very limited utility.

Related to limitations on derivative suits is the traditionally high burden of proof for establishing corporate waste, the cause of action most often relevant to executive compensation. Indeed it is safe to say that, until recently, waste was an almost impossible cause of action to sustain, even assuming one got past the initial procedural limitations of derivative litigation.

As Labaton and Stocker explain, the main culprit limiting derivative litigation is the power of a corporate board to appoint its own special litigation committee, with all of the real (but, according to courts, not disabling) problems of structural bias that the special committee’s decision-making process, and judicial deference to it, creates. Balancing the concerns of courts and policymakers that derivative litigation will be frivolously brought with the real need for shareholder enforcement, Labaton and Stocker propose amending derivative litigation rules by incorporating procedures familiar under federal class action reform. In particular, they suggest that demand rules be relaxed for significant shareholders, those holding more than 1 per cent of the corporation’s stock (or $25 million of the corporation’s stock in the case of small cap companies), as well as a six-month holding period prior to initiating suit. Courts can reasonably be assured that such shareholders have real interests at stake and are not acting frivolously in bringing suit.

Once past the hurdles of derivative suit procedures, plaintiffs face the formidable burden of the business judgment rule, which typically applies even to executive compensation issues. However, Labaton and Stocker see promising signs – both in the writings of several Delaware judges as well as recent Delaware case law – indicating that the law is beginning to acknowledge the problems of excessive compensation and to increase the legal opportunities for redressing those problems through strengthened prohibitions against corporate waste. Together with reform in the derivative litigation process, Labaton and Stocker see new hope for the possibility of restraining executive compensation that bears little relationship to performance or rationality.

In the final chapter in this volume, Arthur Wilmarth examines the Supreme Court’s recent decision in *Cuomo v. Clearing House, L.L.C.*, and he contends that the decision can best be understood as the Court’s response to the subprime financial crisis. In *Cuomo*, the Court held that the Office of the Comptroller of the Currency (OCC) exceeded its authority when it adopted a regulation in 2004 that barred state officials from filing
lawsuits to enforce applicable state laws against national banks. *Cuomo* arose out of an attempt by the New York Attorney General (NYAG) to enforce New York’s fair lending laws against several large national banks that were heavily engaged in nonprime mortgage lending. By affirming the NYAG’s authority to enforce state mortgage lending laws through the courts, the Supreme Court exhibited a perspective on banking regulation that sharply contrasted with the Court’s approach two years earlier in *Watters v. Wachovia Bank, N.A.*

In *Watters*, the Court upheld another OCC regulation, which preempted the application of state laws to nonbank mortgage lending subsidiaries of national banks. As Wilmarth explains, *Watters* took a broad view of the preemptive reach of the National Banking Act and indicated that national banks would not benefit from any supplemental regulation by the states. In *Cuomo*, however, the Court took great pains to limit the precedential force of *Watters*. Moreover, *Cuomo* indicated a renewed appreciation for the historic role of the states in regulating financial institutions and protecting consumers. Three members of the Supreme Court (Justices Ginsburg, Breyer, and Souter) switched from supporting the OCC in *Watters* to opposing the OCC in *Cuomo*. Wilmarth believes that their positions changed because they modified their views about the merits of the OCC’s preemptive regime and the value of state regulation between April 2007, when *Watters* was decided, and June 2009, when *Cuomo* was issued.

Wilmarth suggests that the most plausible explanation for the three Justices’ change in perspective is that they were influenced by the outbreak of the subprime financial crisis in August 2007 and subsequent federal bailouts of several major national banks that were deeply involved in nonprime lending. Amicus briefs filed in support of the NYAG included numerous references to the financial crisis. In addition, the briefs sharply criticized the OCC for its sweeping preemption of state laws and for its weak record of protecting consumers from abusive lending practices. Statements made by Justices Ginsburg and Souter during oral argument in *Cuomo*, and also by Justice Stevens in his dissenting opinion in *Watters*, indicate that the Court was aware of the mortgage crisis and the growing controversy over the OCC’s preemptive actions.

In Wilmarth’s view, *Cuomo* represents a much-needed affirmation of (i) the principles of regulatory federalism inherent in the dual banking system and (ii) the central importance of consumer protection in preserving financial stability. In addition, *Cuomo* supports current legislative proposals by the Obama administration, which seek to preserve the states’ longstanding role in protecting consumers of financial services. Like Patricia McCoy’s earlier chapter, Wilmarth’s chapter shows that, during the past decade, the states have been far more proactive than the OCC and other federal
agencies in enacting laws and bringing enforcement proceedings to protect consumers against predatory lending and other abusive financial practices. The subprime financial crisis has demonstrated that effective consumer protection (including the prevention of predatory lending) is closely linked to the safety and soundness of financial institutions. Wilmarth argues that the states’ positive record of legislation and enforcement over the past decade has confirmed the wisdom of preserving a federalist system of financial regulation, which includes not only a federal component but also a supplemental state role in enacting and enforcing consumer protection laws.

Wilmarth suggests that the only disappointing aspect of Cuomo for the states is that the Supreme Court failed to resolve a recurring issue about the appropriate level of judicial deference that federal agencies should receive when they claim authority to preempt state law. Cuomo did not follow a relatively demanding, four-part framework for judicial review of agency preemption claims that Justice Stevens developed in his opinion for the Court in Wyeth v. Levine. Instead, Cuomo left open the possibility that future preemption claims by federal agencies may receive a more accommodating level of judicial deference known as ‘Chevron deference’. However, the Court in Cuomo refused to defer to the OCC’s preemptive regulation, based on the Court’s conclusion that Congress did not delegate the preemptive authority asserted by the OCC. Cuomo indicates that, even if the Supreme Court chooses to apply Chevron in future cases involving agency preemption claims, the Court may apply an enhanced level of scrutiny with regard to the issue of whether Congress actually delegated the preemptive power claimed by the agency. While Cuomo does not resolve this important question, the broader context of the decision reveals that the policies of all three branches of the federal government, and those of many state governments as well, have been deeply influenced by the ongoing financial crisis.

As we noted above, it is far too early to understand all of the causes of the current crisis, and it would be presumptuous to offer any comprehensive analysis of the direct and indirect effects of the crisis or the best remedies for the problems we presently confront. If the history of the Great Depression is any guide, our descendants will continue to debate these issues 80 years from now. Despite the limitations of trying to understand interesting times while living through them, the essays in this volume present, we hope, a useful first step in understanding not only the causes of the Panic of 2008 but also its consequences and implications for reform.

Lawrence E. Mitchell
Arthur E. Wilmarth, Jr.
1 November 2009
NOTE

1. As we write this introduction, the Obama administration has been forced to concede one aspect of its consumer protection plan, including the proposal that financial services companies should be required to offer straightforward ‘plain vanilla’ products like 30-year, fixed-rate mortgages and low-interest, low-fee credit cards. Stephen Labaton, ‘White House Pares Its Financial Reform’, www.nyt.com, 23 September 2009. Whether these concessions are bellweathers for other problems the plan will encounter will only be revealed over the course of time.