Commentary, The Perils of Public Finance

Alvin C. Harrell, Oklahoma City University School of Law

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Commentary: The Perils of Public Finance

By Alvin C. Harrell

Alvin C. Harrell is a Professor of Law at the University of California and President of the Home Savings and Loan Association of California. He is a member of the American Bar Association's Committee Task Force on Certificate of Title Laws and was Reporter for the NCCUSL Uniform Certificate of Title Act (UCOTA). He is Executive Director of the Conference on Consumer Finance Law and a member of its Governing Committee, a member of the American Law Institute (ALI), a member of the American College of Financial Lawyers and the American College of Consumer Financial Service Lawyers, and served as Chair of the Financial Institutions and Commercial Law Section of the California Bar Association. He chairs the UC Legislative Review Subcommittee of the California Bar Association.

I. Introduction

The Introduction to the 2009 Annual Survey of Consumer Financial Services Law included an observation that now is apparent (but perhaps seemed less so when that article was written in late 2008): Public policy at the federal level (and in many states) is imposing restrictions that diminish the availability of private consumer credit, relying instead on public programs and expenditures to resuscitate the housing and credit markets. This current phase of this trend in consumer credit law can be said to have begun with HOEPA in 1994, but has dramatically accelerated.

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Associated Press. Mortgage rates drop to new low of 4.75%. Oakland, Calif., July 2, 2009, at A1. (The rates have yet to fuel home sales. See e.g., Frank, New Home Sales Stodgy, but No News on Fannie, Freddie, on RSP, Paulson economist Anna Peek: 'The housing rebound has so far been largely supported by government programs. . . . I think the government is getting too involved.' It's a market in which it has privileged its'instants' collectively made by funders, investors, and mortgage lenders to evaluate the viability of your tax dollars given to the government.' And, '80 percent of the stock mortgage transactions are funded by bridge funds, investors, mortgage insurance, and state and local programs.' See e.g., Reutlinger & Ickes, The American Banker, July 7, 2009, at 1A.)
over the past five years, contributing to a private mortgage credit contraction that began in 2006–2007 and has had major adverse consequences for housing markets, communities, consumers, investors, and the entire economy. This was clearly the major "trigger" for the current economic recession. It has been followed by waves of consumer protection and economic stimulus efforts, including bailouts, credit subsidies and other programs, and unprecedented fiscal and monetary policies, which, at this writing, have failed to adequately replace the resulting exodus of private capital from the financial markets. As discussed in this article, many of these policy initiatives have been ineffective, except for their adverse secondary effects, and some have been truly counterproductive.

In view of these continuing policy errors and adverse consequences, it is appropriate to consider the viability of this basic policy approach as a strategy for dealing with the challenges and needs of consumers and the mortgage credit system. Overall it is apparent that, with few exceptions, policy makers have yet to reach an appropriate balance between the need to provide adequate consumer safeguards and at the same time preserve the fundamental contract and property law principles that are essential to routine credit transactions, and that this failure is a basic source of the current problems in the economy. Partly this failure is a result of inherent dynamics in state law and our federal political and administrative systems. As a result, recent policy initiatives have consistently favored public over private funding, and a relatively small number of institutions over smaller institutions and perhaps the broader needs of the economy. As one might expect, given the subtlety of these issues, leaders in both political parties and the popular media have largely missed this story, instead focusing on such things as the resulting bank profits and bonuses and favoring financial bailouts and expanded powers for some of the same entities whose behavior contributed to the current crisis.
II. The Centralization of Mortgage Finance

A. A New Legal Environment

We are now living this future, and the question is: Does it work? In the past decade, and particularly over the last five years, some state legislatures, the Congress, and federal agencies have imposed extensive new compliance requirements and legal restrictions on private mortgage lending transactions and their enforcement (with resulting increases in legal complexity, regulatory burdens, and liability risks), making such transactions legally and financially more hazardous. And anyone who reads a daily newspaper can see that more is the on the way. Although public figures and the media seem oblivious to the consequences, the practical result has been a withdrawal of private capital and a widespread decline in private mortgage lending. Those who have long argued that too much private credit was being made available now have their wish, though perhaps with economic consequences not everyone anticipated (or understands, even now).

This steady march of new restrictions on mortgage and other consumer credit has often had broad bi-partisan support and has been endorsed through several Presidential administrations. Under the basic Bush-Paulson-Bernanke-Obama-Geithner-Dodd-Frank approach, the resulting credit crunch is being addressed by massive federal lending, injected directly into the financial system (e.g., by TARP) and indirectly through off-balance sheet mortgage operations and FRB lending. While a stated purpose...
is to "jump start" private lending, it seems clear that efforts to encourage traditional private lending are not a part of the plan, and that such funding will not voluntarily return to the mortgage markets so long as there is a continuing bottleneck in the form of an unrealistic legal environment for such transactions. Barring rational legal reforms, it is doubtful that any amount of federal stimulus or monetary accommodation will generate a broad-scale return of private funding to the levels necessary to maintain healthy mortgage markets.

This means that mortgage lending will continue to be tied closely to federal funding, e.g., through a few large banks, the FHA, Fannie Mae and Freddie Mac, the FRB, and perhaps the FDIC. Obviously, the nature and size of these programs suggests the enormity of the funding that can be provided in this way (though also the enormous losses that can result), as well as the creative ways that such funding can be masked. For example, one apparent purpose of the TARP program and recent FRB subsidies for large banks was to prevent the claims that would be made against the FDIC if those institutions failed; the FDIC in turn has returned the favor by allowing further leveraging of the contingent liabilities of the FDIC, along with other proposals to utilize off-budget federal guarantees of private obligations.

Clearly, in both size and scope, the 2008–2010 spending, subsidy and bailout programs are unlike anything in the nation’s history. At this point, a brief historical overview of more traditional mortgage finance mechanisms may be helpful in considering how we got here, and where we are going.

B. Historical Perspective

Throughout history, residential mortgage finance has been a challenge for Americans and society. Historically, as can be seen from travel to almost any country outside the U.S., ample housing finance has been available for political and commercial elites (as evidenced by the magnificent edifices they built, often tourist attractions). The average citizen usually has fared more poorly, a reason why his or her abode is less likely to have survived (and is less likely to be visited by tourists when it does).

Things have been somewhat different in the United States. First, the availability of land in the westward expansion, together with the extension of common law property and contract rights to protect private ownership of that land, created opportunities and incentives for home ownership perhaps unprecedented in human history. This created something of a tradition, and expectation, of private home ownership that continues today as an important facet of the “American Dream” (a goal that continues to attract immigrants and ambitions to this day).

Many early settlers of the American West built their own homes, largely by themselves or in cooperation with an extended family of friends and neighbors, often using local materials yielded by the land. Mortgage finance was limited, but where available was provided in part by cooperative associations (forerunners of credit unions and the savings and loan industry) and facilitated by the era of "free banking," when entry into the banking business was as easy as starting a corporation is today.

This private credit fueled the westward expansion and created the foundations of modern America, in

20. (Continued from previous column)
stark contrast to the experiences in similar areas of many other countries.

During the American Civil War, the federal government funded military operations in part by seeking to consolidate banking authority at the national level. By taxing state bank notes (then a primary form of currency), it was intended that the role of state-chartered banks could be reduced or ended in favor of a national banking system. Ironically, both state and national banks responded by resuming the use of paper currency.

But this, alone, was not enough to fill the need for mortgage lending, and the end of free banking meant an inevitable consolidation in commercial finance, and in turn an insufficient availability of long-term home mortgage loans, just as the demand was increasing dramatically. Thus, beginning around 1830, to help fill this void, came the advent of building and loan associations, as both a logical successor to the cooperative efforts that helped build the frontier and a precursor to the Twentieth Century savings and loan industry. By the early Twentieth Century the thrift industry had become a major factor in home mortgage finance in the United States, and as such was important to the growth of civil society and maintenance of the American Dream of home ownership. But this economic model met a gale force headwind (its own “perfect storm”) in the Great Depression of the 1930s.

In the 1930s, the New Deal response was to federalize the thrift industry and its system of home mortgage finance. This story has been recounted elsewhere, and need not be repeated here, except to say that the result was a heavily-regulated thrift industry governed by a tightly-restricted federal business plan. This included a legal requirement for thrifts to invest almost exclusively in long-term, fixed-rate home mortgage loans, a prescription for disaster when inflation and interest rates rose dramatically in the 1970s and 1980s. The resulting insolvency of many thrifts, and the thrift deposit insurance fund (the FSLIC), meant the demise of much of the traditional thrift industry by the end of the 1980s (blamed, ironically, on the very limited “deregulation” of the early 1980s, a last-ditch effort to stave off precisely this crisis). By the early 1990s this left some observers with concerns that the next problem would be an inadequate supply of mortgage credit.

Some of these observers (and advocates) saw expanded federal funding and credit allocation as the preferred remedy. An expanded Community Reinvestment Act (CRA), a new emphasis on creative fair lending theories and enforcement, the growth of Fannie Mae and Freddie Mac, a highly-expansionary FRB monetary policy, regulatory encouragement for bank holding companies to venture heavily into mortgage originations and finance, and various other political and regulatory initiatives were utilized to encourage home ownership and mortgage finance as a national goal. But, perhaps to the surprise of nearly everyone, once again it was private sector practices (this time including securitization), founded largely on voluntary arrangements and common law principles, that did the most to fill the void left by the widespread demise of the traditional thrift industry. And it worked (helped along by Fannie and Freddie, and the FRB), at least for awhile, creating an unprecedented, nearly fifteen-year housing and consumer credit boom (roughly 1993–2007), until a legal and political backlash that began in the 1990s and intensified in the first decade of this century (and especially over the past five years) finally created so many barriers to private mortgage finance that private capital got the message and withdrew.

We all know what happened next. With the private mortgage system in tatters, and “reformers” piling on evermore-burdensome restrictions, it is clear that the traditional American system of private mortgage finance has been cast aside by many state and federal policy makers. And so the question is: What

35. See, e.g., Alvin L. Harrell, Deposit Insurance Issues and the Implications for the Structure of the American Financial System, 130 Ohio State Bus. J. 1, 199 (1993); for a modern equivalent, consider Fannie Mae and Freddie Mac. See, e.g., supra notes 6 and 9.
36. See, supra, note 39.
37. See, supra, note 39.
38. See, supra, notes 39 and 41.
40. See notes cited supra note 32.
41. See supra note 32, Chs. 2.
42. See supra notes 32, 33, and 35.
43. See generally Ted W. Plaze, Residential Mortgage Securitization and Consumer Welfare, 61 Consumer Laws J. 1, 742 (2008);亦 see, supra note 35.
44. See supra notes 32, 35, and 39.
46. See, supra note 39.
47. See supra note 39.
happens now? Clearly, the favored policy alternative is a centralized system of federally-sourced mortgage funding, coupled with increased restrictions on private credit transactions.\(^\text{44}\)

And so, this article addresses the next question: What does all of this mean for consumers seeking credit to buy a home, and for the economy as a whole?

III. The Shape of Things to Come: Potential Consequences of a Reliance on Public Funding

Financial predictions are notoriously unreliable (try to name a public figure, economist, or media commentator who has accurately predicted anything in recent years),\(^\text{45}\) but it seems that some observations and probabilities can be safely drawn from the recent events and policy shifts.

A. Centralization of Underwriting Standards

To the extent that our traditional, decentralized loan underwriting system (implemented independently by numerous local sources of credit) is being replaced by a policy-based system of funding, there will be a continuing increase in the centralization of loan underwriting standards and criteria. This means a continuing shift to a rules-based, centralized system of credit allocation, in lieu of our traditionally more diverse, judgement-based system (in which one creditor’s underwriting judgment could be different from another’s)—so that a loan applicant denied by one creditor might be approved elsewhere.\(^\text{46}\) In the new, centralized, rules-based system, uniformity prevails, but flexibility is lost.

No doubt this provides benefits including a legal defense for creditors, against liability for unlawful discrimination. But while uniformity in the law is often a good thing (depending, of course, on what the law says), uniformity in credit criteria is a more mixed blessing: among other things, it means that there is essentially no recourse for an applicant who falls outside the requirements of the uniform criteria.\(^\text{47}\) Along with anti-predatory lending rules and other restrictions in consumer protection laws, this may effectively cut off traditional sources of private credit for many consumers, leaving federal subsidy programs as the only alternative source of legitimate funding. A consumer who fails to qualify for these programs may be simply out of luck, except for illegal sources of credit.\(^\text{48}\) At least this will save consumers the effort needed to “shop around” for alternative sources of legitimate credit—being denied by one government-related creditor will essentially mean denial by all.

B. Favored-Group Bias

As it becomes more apparent that segments of society are being excluded from the financial system by reason of state and federal laws and regulations, it is likely that expanded government credit allocation will again be in vogue as the preferred solution. This is now increasingly to special credit programs for underserved groups favored by public policy. It is not unlikely that, to some extent, these favors will be related to electoral support (probably an inevitable consequence when politics and finance are intertwined). This will strengthen the ties between financial resources and politics, as well as the importance of favored-group affiliations.\(^\text{49}\)

One can hope that out of this will come low-cost credit for some deserving consumers, that otherwise they would not get, and no doubt in some instances this will occur (probably at some cost in terms of taxpayer losses and misallocation of resources in other cases). But, no matter how beneficial this is, it

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44. See supra Parts I and II A. Bear Stearns. Opinion, Preparing for a Recession/Recession Wall St. J., Dec. 29, 2009, at A19 (“the Obama administration and FDIC are pushing forward with plans to nationalize credit creation and “stabilize” the private sector by spending its stock.”)

45. See supra Parts I and II A. Bear Stearns. Opinion, Preparing for a Recession/Recession Wall St. J., Dec. 29, 2009, at A19 (“the Obama administration and FDIC are pushing forward with plans to nationalize credit creation and “stabilize” the private sector by spending its stock.”)

46. See, e.g., Justin Lahart, Who’s Winning? Who’s Losing?, Wall St. J., Feb. 5, 2010, at B6; the 2009 Wall Street Journal’s “Perils of Economic Forecasts” (all of the economists...were blindfolded by the depth of the recession.”). For an extensive and amusing rant of examples in a related context, see L. Gordon Cullace, Information Technology: Predictions Are Hard, Wall St. J., Dec. 25, 2009, at A15 (describing that many of the predictions for 2010 (i.e., technology predictions) “are widely reported expectations that are severely flawed in retrospect.”)

47. See supra Part I. Bear Stearns. Opinion, Preparing for a Recession/Recession Wall St. J., Dec. 29, 2009, at A19 (“Soon, the two most important financial decisions must families make to get a mortgage and to take a college loan: will always be transactions with the government.”)

48. See supra note 44. Bear Stearns. Opinion, Preparing for a Recession/Recession Wall St. J., Dec. 29, 2009, at A19 (“the most important financial decisions must families make to get a mortgage and to take a college loan: will always be transactions with the government.”)

49. See supra note 44. Bear Stearns. Opinion, Preparing for a Recession/Recession Wall St. J., Dec. 29, 2009, at A19 (“the most important financial decisions must families make to get a mortgage and to take a college loan: will always be transactions with the government.”)
blurs the distinctions between policies, finance, subsidies, and welfare, and the costs will be borne by other taxpayers and borrowers (e.g., consumers whose private savings and incomes are reduced by inflation and/or higher taxes). Such programs are not free, and it is inevitable that those who are not favored by the proper affilliations will pay for those who are, and that some deserving but unfavored borrowers will simply be left out.

C. Subsidy Effects

As suggested above, all of this inevitably means an expanded involuntary income and wealth transfer, probably from middle-class taxpayers who do not qualify for bailouts or credit subsidies, to more-favored recipients. Indeed, it is likely that the economic policy advice given to the United States was more about advancing the interests of those who have been benefited than about focusing on the distributional effects of federal and economic policy. See, e.g., Mark L. Hasl emot, The Development of Consumer Protection Law, the Institutionization of Consumerism, and Future Prospects and Perils, 39 Geo. St. Univ. L. Rev. 117, 199 (2010) (noting the efforts of consumer level organizations to "change the distribution of society's benefits").

D. Uncharted Territory

It is this latter factor that thrusts consumers, creditors, and the new legal and financial environment into uncharted territory. Those advocating on behalf of the well-favored expansion of centralized regulation, underwriting and public funding of consumer and mortgage credit, even as private capital is driven away by an increasingly onerous legal environment, may argue that this is an evolutionary change rather than a dramatic departure from prior practice. After all, government funding and allocation of mortgage credit has been with us for a long time, e.g., via federalization of the thrift industry in the 1930s, and later the CRA, fair lending initiatives, FHA lending programs, federal banking regulation, and of course Fannie Mae and Freddie Mac. But this argument understates the importance of the current shift from private to federal loan programs, underwriting, regulation, and funding. As noted above, the nearly complete reliance of the mortgage markets on a centralized, rules-based federal system (e.g., on the model of Fannie and Freddie) and the displacement of private alternatives essentially means the end of flexible, decentralized and judgement-based private finance. This has never happened before in the history of American finance.

This creates a whole new range of fundamental issues. For example, it is not the case that a decentralized system that it requires individualized, local, even face-to-face judgement in order to be successful. Low-documentation or no-documentation lending is quite feasible in this context, but it requires sound and flexible judgements based on factors that may not be revealed in standardized written applications. Given the wide variations in human needs, behavior and circumstances, a large number of borrowers need this kind of financing, for a multitude of completely legitimate reasons. A highly-centralized loan underwriting system is ill-suited to such transactions.

A truly radical aspect of the new credit environment is that it not only provides public funding and underwriting mechanisms that are not well-suited to individualistic or creative financial arrangements, it significantly discourages alternative mortgage financing arrangements through private

51. See supra notes 1-9 and 58-59 and accompanying text, and infra note 52. Indeed, it is likely that the economic policy advice given to the United States was more about advancing the interests of those who have been benefited than about focusing on the distributional effects of federal and economic policy. See, e.g., Mark L. Hasl emot, The Development of Consumer Protection Law, the Institutionization of Consumerism, and Future Prospects and Perils, 39 Geo. St. Univ. L. Rev. 117, 199 (2010) (noting the efforts of consumer level organizations to "change the distribution of society's benefits").


53. Indeed, that is partly what caused the current problems. See, e.g., supra note 51, and supra notes 5 and 56-58.

54. See supra notes 3, 5, 9, and 41-43. As noted above these sources, the mortgage finance industry has been essentially nationalized, in conjunction with a legal environment that effectively disfavors private alternatives. In consequence, roughly 90.0% of mortgage finance is being provided by the federal government. See also supra note 51. See supra note 51. Review & Outlook, The Fannie Mae Case, Wall St. J., Nov. 19, 2009, at A30, Headed on the Street, "In a New Era, the House on Mortgage, Wall St. J., Sept. 16, 2009, at C2.

55. See supra note 51, supra Part II and infra Part VI.

56. See, e.g., George Will, Misfortunes and Financial Meltdown, Oklahoma, Oct. 25, 2009, at A8 describing a partial list of recent forays into artificial construction and institutional documentation—puzzles for the financial industry. Not the least of these is the lack of a traditional credit-based economic recovery. See also supra notes 2 and 4, and 41-43, and supra Part VI.

mechanisms. This may be the first time in our history that the failure of large publicly-regulated and publicly-funded entities and credit programs resulted in public policies designed to shut-off the private alternatives. In turn, the resulting lack of private credit is commonly cited as a reason for further expansion of the failed federal programs, creating an expanded range of political "moral hazards."59

The resulting shortage of private credit alternatives is part of what makes it different this time, eroding the relevance of previous economic experience. As a result, predictions based on previous economic cycles have been less reliable than usual.60 For example, if the current legal environment had been in place after the demise of the traditional thrift industry in the late 1980s and early 1990s, private mortgage loan securitizations likely would not have expanded to fill the void.

This is no doubt a point of those advocating such restrictions—restricting private credit in order to protect consumers from the losses suffered in 2008–2010. But the result twenty years ago would have been a protracted mortgage and credit crisis, perhaps extending through 1993–2007, rather than a fifteen year economic boom. Today, such private sector solutions have been effectively precluded by the new legal environment, particularly with regard to subprime mortgage transactions, and the country is suffering just such a crisis. Many traditional credit transactions are effectively prohibited, and the economy is left adrift in uncharted waters.

E. The Impact on Credit Judgement

There is considerable support for this new state of affairs, and probably many observers view it as inevitable, as the advocates of a comprehensive administrative state have been gaining ground in government, the media and academia for decades at least, and the policy trend has accelerated notably in the past five years. In the 1980s, a federal banking regulator explained to you that the "we can't have lenders out there just loaning money to anyone they want." It was a revealing comment that heralded the coming era of regulatory credit allocation. Since then, credit-scoring models and regulatory guidelines have come to be a primary basis for mortgage lending, partly as an insulation against ECOA liability,61 and partly due to the more centralized credit underwriting processes inherent in an era of securitization, activist regulation, nationwide lending programs, and financial institution consolidation.62 A related factor has been the expansion of Fannie and Freddie.63

Your author appreciates the benefits that result from securitization, uniform regulatory guidelines, credit-scoring models, and a national mortgage market, including (in some instances) improved credit underwriting analyses and decisions (although recent experience may cast some doubt on that theory), and (in combination with securitization, or perhaps government subsidies and funding) lower credit costs for many mortgage borrowers.64

But as usual there are also downsides.65 Your author has observed, many times, that applicants rejected under widely-accepted credit criteria can nonetheless be successful borrowers and homeowners when given the opportunity to obtain credit pursuant to old-fashioned credit standards based on personal judgement and flexible lending criteria. And it hardly need be noted today, in view of the continuing problems in housing and mortgage finance, that sophisticated credit-scoring models are not infallible.

Credit-scoring models are fine, even necessary for many transactions in today's world of nationwide lending programs and world-wide credit markets. But, as noted, today's policy approach is historically different in that it simultaneously includes efforts to discourage local, private alternatives,66 even as a supplement or safety-valve for federal programs. If this means the end to a significant role for local credit judgement, it is a loss for consumers and the American financial system.67

F. Political Risks

Obviously (and as noted above at Parts III.B. and C.), when subsidies and credit are publicly-funded they are also publicly-allocated, and therefore susceptible to political influences. Some of these issues have been noted above.68

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62. See, e.g., Wallace, supra note 47; Alan C. Harrell, The Great Credit Contractions: Why What Where Why and Why, 26 Geo. St. Univ. L. Rev. 1297, 1297 (2010). The argument that these factors are credit-card oriented is based on the current credit crisis, and that the recent problems in the credit markets are the result of "disenchantment", or, of course, a favorite of those seeking more regulation, but most seem logical to those familiar with the steady march of increasing regulation in recent decades. See, e.g., Dublin, supra note 52; Associated Press, Fannie, Freddie Offer More Aid to FHA Loans, Oklahoma, May 9, 2009, at 3; securitization plans to nationalize Ginnie Mae, and turn it into "the Freddie Mac and Fannie Ma ne of auto finance..."
63. A moral hazard is created when those responsible for causing problems are allowed to benefit from them, at the expense of innocent parties. See, e.g., supra note 9, infra Part III.G. See also supra notes 50 and 54–55.
65. See also supra Parts III.A. and B.
66. See supra note 47; Window, supra note 47; supra notes 44, 45, and 47.
67. See supra note 47. Of course, as noted, to some extent such transactions will merely be driven outside the local system. See supra notes 47 and 49.
68. See also supra notes 47–52 and supra text at Parts III.B. and C.
but there are other risks as well. There has been discussion elsewhere about the commercial risks of the politicization of credit law and institutional management. But there are similar risks at a somewhat more mundane level.

There is an obvious temptation for government-connected enterprises to direct their activities in ways designed (at least in part) to satisfy the most powerful political constituencies, or even to influence elections. Your author recalls examples, going back to the 1960s, of federal regulators becoming very aggressive, insistent even, in demanding that individual institutions dramatically expand their lending activity to support specific housing programs, or in crucial election years. Perhaps it was all just coincidence, but overall the risk of misallocation seems apparent, especially given the "moral hazard" of taxpayer risk when such efforts go awry. Probably we can expect more of the same in future years. Perhaps, this is an inevitable aspect of government funding, regulation, and subsidies. One cannot blame interested parties for wanting to get in on it. But one thing seems clear: As the scope of public funding and regulation increases, so does this effect, along with the inevitable moral hazard of private gains funded by public risks.

G. Moral Hazard

Today it is a distant memory: The public outcry and widespread outrage over "S&L Kingspins" and financial insolventies in the 1980s highlighted how the "moral hazard" inherent in the deposit insurance system contributed to the financial crises of the time (essentially, insolvent institutions were encouraged by nearly everyone to "grow out of their problems" as an alternative to being shut down by regulators, by using FDIC or FSLIC deposit insurance to attract new deposits). If the strategy had succeeded, the regulators and executives involved would have been congratulated as financial geniuses and handsomely rewarded; but when it failed, the taxpayers bore massive losses. Hence the "moral hazard" created by separation of the reward from the risk. The decade of the 1980s ended in financial disaster for the deposit insurance funds, taxpayers, and much of the federally-regulated financial system, amid cries that the resulting regulatory expansion would ensure that it would never happen again.

All of this is apparently forgotten now. "Never again" is neither recalled nor repeated, as the federal government essentially "doubles-down" its bet on federal mortgage and housing programs, credit subsidies, and guarantees (all but assuring repeat performances at some point). The 1980's regulatory reforms designed to prevent a recurrence (e.g., prompt corrective action, increased capital requirements, mark-to-market accounting, etc.) have been quietly postponed or deemphasized (though it should be noted that all three issues remain alive). The "moral hazard" inherent in using taxpayer funds to preserve large insolvent institutions has been discussed but if anything effectively reinforced, or even expanded and formalized. Reform ofannie and Freddie is a distant dream. Only the continually increasing federal regulatory authority and burdens remain. Such increases are always the preferred solution for problems essentially caused by the imposition of increased regulation in response to previous crises.

76. See supra notes 36-37. Thus, as now, the culprit was said to be "decapitalization." See, e.g., Snell & Stamey, supra note 42. Such criticism is helpful, if the goal is to repeat the same mistakes that caused the current crisis. See, e.g., supra notes 36-38; Steve Chapman, Repealing Our Financial Mistakes, Oklahoma, June 24, 2009, at 104; other sources cited supra at notes 36, 38, 41, 53, 71, 72, 73.

77. The term "too big to fail" is said to have first been used by Alistair Darling Minister of Treasury and the Lord Chancellor, the Treasury, in Parliament for the Union and the United Kingdom, July 15, 2009, at 15.

78. It is not clear to your author why anyone thinks the new Bureau of Consumer Financial Protection (CFPB) created in the Dodd-Frank Act will be any different in this regard. See, e.g., a Honorable, Consumer Financial Protection Bureau, The Proposed Consumer Financial Protection Bureau, 1 U.S. Consumer Fin. 1, Rep. 140, 2009. Of course, advocates of the CFPB expect that it will be staffed with persons to whom "too-big-to-fail is too big.

79. See, e.g., Varney, supra note 19.

80. With a result that the losses to the public were dramatically increased. See, e.g., David Wessel, Capital, Small Banks and the Risk, Wall St. J., June 12, 2009, at A1. "Here's another problem: The Congressional Budget Office estimates that more than half the $34 billion in today's delivery for the savings and loan rescue is still uncollectible, and instead of justifying them when they become insolvent, it rationalizing that this is essentially the policy again today, for the entire financial system. Regarding political moral hazard, see supra Part III.C.2. See supra note 62; supra notes 36-37.

81. At the time, given the nature of youth, your author was shocked, since there, I have seen much worse. For a more recent example, see, e.g., Liz Rapaport, Lewis Says F.C.S. Ordered Silence on Deal, Wall St. J., April 23, 2009, at A4; Review & Outlook, Bloomberg, supra note 69; see infra note 6.

82. See infra notes 70-72.
Too-big-to-fail (TBTF) is now so thoroughly ingrained in American public policy that counterparties are encouraged to believe that in transactions with large institutions of almost any kind they are essentially dealing with the U.S. government. Contrary to public hype, the risks have been increased. There has been no serious effort to reform Fannie and Freddie, eliminate TBTF, constrain deposit insurance, or significantly limit any other aspect of the moral hazard that consistently contribute to our recurring credit and financial crises. Many of the benefits go directly to influential counterparties and highly-paid corporate insiders (at least until they lose favor with government officials and are replaced); when the risks go bad, the costs are borne by taxpayers (who are about to be hit directly in their pocketbooks), typically amid another regulatory expansion (sometimes accompanied by rosy predictions about the future, including the potential for taxpayer profits in ideal scenarios).

Far from being banished, TBTF and moral hazard will become pillars of American economic policy and regulation.

H. Rising Costs

The embrace of moral hazard and TBTF as foundations for public policy is not a cost-free exercise, although (like Social Security, Medicare and FDIC insurance) it is often presented as such in the public discourse. Obviously, it is difficult enough for the public to visualize on-budget issues such as federal spending and taxation; it is almost certainly too much to expect the general public or the popular media to contemplate (beyond the pronouncements of public officials) the implications of such things as government guarantees and regulation, contingent liabilities, an expanding FRB balance sheet, and aggressive open market operations.

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76. (Continued from previous page)

77. See, e.g., Taylor, supra note 36 (the problem of "too big to fail" remains, and any cozy relationship between certain large financial institutions and the government that existed before the crisis will continue); see also Peter D. Eisenberg, A Path Toward a Sounder Financial System, Wall St. J., Mar. 29, 2010, at A14 ("smarter" regulation may be the key to the sounder and safer financial system that came untied in this crisis); see Essay, Taxation, Risk and Private Banking, 87 Va. L. Rev. 417 (2001); see also C. Jones, supra note 13 (the cost of a financial collapse is far too great). Conversely, one might expect that the current and deposit rates of systematically important banks in the U.S. will continue to benefit from "too-big-to-fail" support and that the result will be increased support for financial institutions in the financial system). Ditto that.

78. See, e.g., J. M. O'Neill, supra note 24 (the risks of TBTF are "too big for no one to fail"); see also supra note 36 (the problem of "too big to fail" remains, and any cozy relationship between certain large financial institutions and the government that existed before the crisis will continue); see also Peter D. Eisenberg, A Path Toward a Sounder Financial System, Wall St. J., Mar. 29, 2010, at A14 ("smarter" regulation may be the key to the sounder and safer financial system that came untied in this crisis); see Essay, Taxation, Risk and Private Banking, 87 Va. L. Rev. 417 (2001); see also C. Jones, supra note 13 (the cost of a financial collapse is far too great). Conversely, one might expect that the current and deposit rates of systematically important banks in the U.S. will continue to benefit from "too-big-to-fail" support and that the result will be increased support for financial institutions in the financial system). Ditto that.

79. How could such an abuse occur? In essence, the fox is guarding the hen house. See, e.g., supra note 75; see also supra notes 2, 9, 20, 25-26, 45-52 and 71-77. Jonathan Macey, Obama and the "Fat Cat" Bankers, Wall St. J., Jan. 13, 2010, at A23 ("Choked-Up" Banks and Government guarantees take the biggest hits, make the most money, and pay the highest bonuses"). Sheila Bair, Chairman of the FDIC, proposed a radical solution to the problem of TBTF institutions: more supervision. See, e.g., supra note 75, supra text preceding.

80. See, e.g., supra note 75. Criticism of the 2008-2010 policy is commonly met by the response that this was necessary to prevent the collapse of the financial system and economy. See, e.g., Alisa B. Weiner, Opposition in the Economic Review, Wall St. J., June 16, 2010, at A17; Levy Pogrebin, op. cit. supra note 24. The New York Times, Financial Turmoil Is Far From Over, Wall St. J., Feb. 18, 2010, at A1; see also supra note 24. See also supra note 75 (the risks of TBTF are "too big for no one to fail"); see also supra note 36 (the problem of "too big to fail" remains, and any cozy relationship between certain large financial institutions and the government that existed before the crisis will continue); see also Peter D. Eisenberg, A Path Toward a Sounder Financial System, Wall St. J., Mar. 29, 2010, at A14 ("smarter" regulation may be the key to the sounder and safer financial system that came untied in this crisis); see Essay, Taxation, Risk and Private Banking, 87 Va. L. Rev. 417 (2001); see also C. Jones, supra note 13 (the cost of a financial collapse is far too great). Conversely, one might expect that the current and deposit rates of systematically important banks in the U.S. will continue to benefit from "too-big-to-fail" support and that the result will be increased support for financial institutions in the financial system). Ditto that.

81. See, e.g., supra note 75.
But of course the use of these federal policy mechanisms is not free. From a political perspective, an advantage is that they may seem so, because (at least in some cases) the precise costs are indeterminate and will not be known until they are realized, which may not happen for some time. When these effects do occur, often they will be so remote from the causes that the blame can be easily deflected elsewhere. For policy makers and executives worried about whether they will have a job (or a bonus) next week, this is a large benefit. But it is not a benefit that extends to the rest of us.

Ultimately, the costs of the current policies may be astonishing to an American public unfamiliar with the human and social costs of severe financial disruptions. The FDIC “funds” was already below its minimal requirement when deposit insurance coverage was increased significantly in 2008; since then policy makers have consistently pursued efforts to further ”leverage” the FDIC as a source of new funding. The FRB has periodically announced new hundred billion dollar credit and funding programs. The announced subsidy for the nationalized GSEs (Fannie and Freddie) were estimated from an estimate of zero (or a profit!) to $25 billion, then $100 billion, then $200 billion, and $400 billion, and finally become unlimited. Estimates of the total federal bailout and stimulus funding now range upwards of $10–$15 trillion, up from $7 trillion in late 2008. Possibly no one knows for sure what all of this will mean, or how it will be paid for, but costs of this magnitude cannot simply be ignored indefinitely. Ultimately, there will be real costs to the American public and our social and economic systems.

History suggests that over time these large deficits, expenditures, bailouts, stimulus programs and subsidies, and the related FRB monetary accommodation, will increase, not decline, and perhaps substantially. At some point, perhaps sooner than we think, someone will have to pay. No doubt some holders of private capital are concerned that it will likely include them.

1. A Flight of Private Capital

It is not surprising that there has been a flight of private capital from some of our markets and institutions, including consumer credit and mortgage markets and some institutional pillars of American industry and finance. Given the resulting world-wide economic and political uncertainty, U.S. Treasury obligations have benefitted as a haven of last resort. If that ever changes, we are in for real trouble.

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81. See supra notes 3, 5, 19, and 62; Harrell, supra note 56. The responsible party, stimulus, and bailout expenditures have sought to stimulate public funding for the bail-out of private capital. But the success of this process is limited by its inability to address all legal impediments significantly responsible for the failure of private capital. See, e.g., supra notes 2–62 and accompanying text. Harrell, supra note 56, at 1254–55, supra note 54.

82. See supra Part III C, supra note 54.

83. See, e.g., Robert C. Page, Opinion, 58000182/A Guide for Fannie Mae’s February 10, 2010, at 20, 2010, at 20; supra note 57; supra note 58; supra note 59; infra note 74; supra note 75; supra note 80; supra note 81; supra note 82; infra Part III D, supra notes 19 and 83.

84. See supra notes 15, 19, and 62; Harrell, supra note 56. The responsible party, stimulus, and bailout expenditures have sought to stimulate public funding for the bail-out of private capital. But the success of this process is limited by its inability to address all legal impediments significantly responsible for the failure of private capital. See, e.g., supra notes 2–62 and accompanying text. Harrell, supra note 56, at 1254–55, supra note 54.

85. See supra notes 15, 19, and 62; Harrell, supra note 56. The responsible party, stimulus, and bailout expenditures have sought to stimulate public funding for the bail-out of private capital. But the success of this process is limited by its inability to address all legal impediments significantly responsible for the failure of private capital. See, e.g., supra notes 2–62 and accompanying text. Harrell, supra note 56, at 1254–55, supra note 54.

86. See supra notes 15, 19, and 62; Harrell, supra note 56. The responsible party, stimulus, and bailout expenditures have sought to stimulate public funding for the bail-out of private capital. But the success of this process is limited by its inability to address all legal impediments significantly responsible for the failure of private capital. See, e.g., supra notes 2–62 and accompanying text. Harrell, supra note 56, at 1254–55, supra note 54.

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89. See supra notes 15, 19, and 62; Harrell, supra note 56. The responsible party, stimulus, and bailout expenditures have sought to stimulate public funding for the bail-out of private capital. But the success of this process is limited by its inability to address all legal impediments significantly responsible for the failure of private capital. See, e.g., supra notes 2–62 and accompanying text. Harrell, supra note 56, at 1254–55, supra note 54.

90. See supra notes 15, 19, and 62; Harrell, supra note 56. The responsible party, stimulus, and bailout expenditures have sought to stimulate public funding for the bail-out of private capital. But the success of this process is limited by its inability to address all legal impediments significantly responsible for the failure of private capital. See, e.g., supra notes 2–62 and accompanying text. Harrell, supra note 56, at 1254–55, supra note 54.

91. See supra notes 15, 19, and 62; Harrell, supra note 56. The responsible party, stimulus, and bailout expenditures have sought to stimulate public funding for the bail-out of private capital. But the success of this process is limited by its inability to address all legal impediments significantly responsible for the failure of private capital. See, e.g., supra notes 2–62 and accompanying text. Harrell, supra note 56, at 1254–55, supra note 54.

92. See supra notes 15, 19, and 62; Harrell, supra note 56. The responsible party, stimulus, and bailout expenditures have sought to stimulate public funding for the bail-out of private capital. But the success of this process is limited by its inability to address all legal impediments significantly responsible for the failure of private capital. See, e.g., supra notes 2–62 and accompanying text. Harrell, supra note 56, at 1254–55, supra note 54.
J. A Declining Dollar

It seems a paradox that, among all of these problems, the U.S. currency has been relatively strong in world markets. The explanation is that this is a reflection of how the economic pain initiated by the collapse of U.S. mortgage and credit markets has spread throughout the world. For decades, the U.S. consumer has provided the fuel for economic growth, overseas as well as at home, and when all of that collapsed with the mortgage credit crisis, the U.S. dollar played its usual role as a monetary refuge of last resort. Given the obvious fears about private credit markets and the ripple effects in other countries around the world (along with an accommodative FRB monetary policy), a beneficiary was the U.S. Treasury and its ability to fund its debt by selling Treasury securities. The resulting capital inflows have strengthened the dollar despite the expansion of the FRB’s balance sheet and very low U.S. interest rates.

While such things are anyone’s guess, there is a likelihood that this will not last forever. Capital inflows (e.g., the purchase of U.S. Treasury securities) as a reaction to even worse problems elsewhere, and a declining velocity in the money supply (e.g., due to the collapse of private mortgage lending and the resulting U.S. recession) can offset an expansive monetary policy, heavy U.S. Treasury borrowing and spending, and low interest rates, thereby stabilizing the value of the currency and restraining the inflation rate, at least for a time. But one need not be a rocket scientist (or professional economist) to realize that this cannot last forever. There is of course a lag time before such policies trigger inflation and currency weakness. Thus, the question is: When and how will this happen?

91. (Continued from previous page)

92. The uniform law process being adopted is an exception. But see, e.g., supra notes 92 and 93. See Part V. This policy failure also has an international aspect. See, e.g., supra Part III.B.

93. (Continued from previous page)


95. The old saying is that when the U.S. economy succeeds, the world economy catches cold. Although often quoted, no one seems to know who said it first. See, e.g., James Grant, The Myth of Globalization: How the U.S. Succeeds, Thomson Reuters, http://www.businessweek.com/magazine/content/05_20/0521025845.htm (Feb. 5, 2005). What is clear is that when the U.S. economy is on a roll, and appears to be taking the world with it. See, e.g., DC/2008, supra note 81; Laffer, supra note 91; Greenspan, supra note 90; O’Grady, supra note 91; Richman Bailey, supra note 81; Financial times, supra note 77. The resulting shift from private to federal spending lies at the heart of Keynesian economic theory, as well as our current economic woes. See, e.g., Melbourne, supra notes 80 and 89-90.

96. See, supra notes 89-97. As also explained in, e.g., Robert B. Reich, “The Anatomy of Obamanomics,” Wall St. J., Feb. 8, 2009, at A17. Of course, this only works if there is a collapse of private credit, e.g., for the reasons noted in this article. See also Harrell, supra note 85. But it is not a new concept. See, e.g., and, e.g., Associated Press, “Brazilians’ Boat Not Sinking,” May 1, 2010, at 31. And, as noted supra notes 89-90 and again immediately below, the adverse effects of these “remedies” cannot be quantified individually, for generally supra notes 85-87, Johnson, supra note 76.

97. See, supra notes 79-80, 89-91. Review & Outlook, “China and the Dollar,” Wall St. J., Mar. 20, 2008, at A12 describing some of the dangers of a weakening dollar. See, e.g., O’Grady, supra note 80; “Global Debt Lessons,” supra note 80. They argue that the Federal Reserve should be focused on keeping inflation in check. See also Greenspan, supra note 80 (the Federal Reserve’s “primary goal is price stability, not growth”). The peak of the Federal Reserve’s inflation target was 2.5% in 2006. See, e.g., Greenspan, supra note 80. The Federal Reserve has lowered its inflation target since then to 1.25% in 2008.

98. See, supra note 89. While the dollar has continued to strengthen, the U.S. economy remains weak. See, e.g., Greenspan supra note 80. The Federal Reserve’s “primary goal is price stability, not growth”). The peak of the Federal Reserve’s inflation target was 2.5% in 2006. See, e.g., Greenspan, supra note 80. The Federal Reserve has lowered its inflation target since then to 1.25% in 2008.

99. See, e.g., and, e.g., Greenspan, supra note 80; O’Grady, supra note 81; Richman Bailey, supra note 81; Financial times, supra note 77. The resulting shift from private to federal spending lies at the heart of Keynesian economic theory, as well as our current economic woes. See, e.g., Melbourne, supra notes 80 and 89-90.
how will the ill effects start to kick-in? When they do, higher taxes will undoubtedly be seen as a necessary response, but there are obvious limits on the use of higher taxes to generate sufficient revenues. The amounts of money being expended by the U.S. government are so large that this revenue source will almost certainly be exceeded. That leaves increased borrowing and inflation as the only alternatives, suggesting that we can expect a significant reversal of the current low interest rate/strong dollar environment at some point in the future, absent an extraordinary, long-term economic weakness that continues to depress the velocity of money and/or unusually strong productivity gains.

K. Subsequent Impact of International Capital Outflows

As noted above, in the U.S. the flight of capital from private mortgage and credit markets (see supra Part III.I) so far has been limited largely to those markets. As also noted above (at Part III.J), the U.S. dollar and U.S. Treasury borrowing efforts have benefited from a corresponding flight to quality, though as noted this may not last forever. Thus, the further possible consequences should be considered.

Of course, some companies (e.g., exporters) favor a weak dollar, as benefiting their competitive position in the short term (until domestic inflation catches up, increasing their production costs to offset the currency advantage). But for the rest of us, the dangers of a weak dollar are manifest: Inflation is just the beginning; higher interest rates and taxes are a near-certainty at some point; even more damaging measures, including price and wage controls, may follow; and economically debilitating capital outflows are a likely consequence, perhaps followed by a formal currency devaluation and draconian restrictions on capital transfers. The world-wide capital inflows that have historically benefited the U.S. economy and helped to fund our economic and mortgage credit boom from roughly 1993-2007 may continue to reverse if domestic credit markets remain unattractive as an investment mechanism (due in part to an oppressive legal environment), and this will worsen if higher taxes and a declining dollar are piled on top of a new layer of economic, regulatory and currency risks. Bad economic policy is a slippery slope, as amply illustrated world-wide and throughout history. No country is immune to such errors. In these circumstances, international capital outflows from debtor nations like the United States are likely to increase (a trend that has already begun, but can become much worse), reinforcing the credit crunch and further damaging productivity and economic growth. We have been there before—in the 1970s—and the results were not pleasant. Moreover, this time (as suggested above) the credit contraction was worse, and was induced not only by monetary and fiscal policy errors but by legal barriers to consumer credit that cannot be addressed by traditional economic measures alone. When the latter measures fail, as apparently they are, we can expect even more draconian measures to be advocated. Capital controls and attacks on capital held abroad are not out of the question—an ultimate form of economic isolationism that cuts off a society from the world and dooms the bases for economic progress as we have known it for hundreds of years. In these circumstances, no prudent person will bring new capital in, and hiding or smuggling out old capital becomes a lucrative fresh source of income for organized (and disorganized) crime. This is not a prescription for a free and prosperous society.
L. Public Anger

Though perhaps few will admit it (and indeed there is much populist rhetoric apparently intended, at least in part, to obscure the point), a consequence of current policies is an overall transfer of wealth, often from ordinary citizens to influential groups including large (e.g., TBTF) institutions and their insiders and other politically-influential constituents. As noted above at Parts III.B and C., and amply illustrated over the past few years, these parties inevitably receive a sizeable portion of any bailout, subsidy and stimulus benefits, regardless of how the payments are structured.

Together with the resulting likelihood of higher taxes, inflation, unemployment, interest rates, and legal costs, this will mean a redistribution of wealth, away from individuals in the private sector to those associated with or benefited by the public sector. The benefits bestowed by this expansion of public finance are necessarily paid for by private citizens through some combination of higher taxes, inflation, and interest rates (along with, possibly, underemployment, undue legal burdens, wage and price controls, credit rationing, capital controls and other legal and regulatory restrictions on private transactions). There is a resulting risk of public anger over the fact that many of the same parties that contributed to the financial problems receive the bailouts using taxpayer funds, enhanced authority, and other rewards (thus triggering the "moral hazards" noted above at Part III.G.). A political challenge, for both political parties, is to channel this anger in directions that favor the desired public policies. But at the same time there is a political risk, for both parties, that electoral success followed by continuing economic failure (and unpopular wealth transfers) will lead to subsequent political rejection. If neither party catches on to an appropriate solution, economic stagnation and turmoil may be joined by increased public anger and political volatility. It is disturbing but not inconceivable that the 2010 street riots in Greece and at the June, 2010 economic summit in Canada could be merely a prelude to more of the same, as the consequences of recent economic, legal and regulatory policies become more clear.

The current series of bailouts and new subsidies and regulations began in (roughly 2008) as a means of stabilizing the financial system and preventing bank runs, a compelling goal (though one may argue that the U.S. Treasury, the FRB, the FDIC, and other financial regulatory agencies were created long ago, precisely for this purpose, and were already endowed with truly massive resources and regulatory power). But the remedial 2008–2010 measures have now become something more, and potentially more dangerous to the economy; the consequences (and purposes) apparently include a restructuring of the American economy and financial system, as a means to effectuate significant redistributions of wealth and income. Absent a real solution that addresses the underlying problems in the legal environment that are impairing private credit transactions, these effects will continue to spread, perhaps along with widespread public dissatisfaction, and if so public officials and media commentators will need truly impressive rhetorical and media skills to smooth it over and disguise the inevitable results.

M. Is the FRB Independent?

The events described here have transformed the image and role of the FRB, e.g., from an impartial and independent arbiter of monetary policy devoted largely to price stability, into a financial facilitator for the executive branch and a partner with the U.S. Treasury in bailing out high-profile (TBTF) enterprises. It may not be clear for

102. The biggest muddiness is the presumption that the government did not have enough power to avoid the crisis. See supra note 72.

103. See supra notes 86-89 and accompanying text. Harrell, supra note 88. See also Michael Froom, Fighting "Monopoly" in Oklahoma, The Oklahoman, Jan. 20, 2006, at A9. (“It is not easy to make a living while a wave of life collapses around you.”) describing the social costs of anger generated by monopolistic banks and the experience of Harrell as an economist at First State Bank, id., at 4A quoting White House senior advisor David Axelrod. “Unfortunately, the party that’s fighting for the middle class... for economic progress... for not Americans... the party that stands up against powerful interests and stands up in defense of the middle class is ultimately the party that’s going to prevail.”


105. See supra note 99. (Footnote 99)

106. See, e.g., Eugene Miller & Harrell, supra note 1, supra note 99.
years (if ever) exactly how and why this transformation occurred, or what the consequences will be, but, given that the FRB is the guardian of the world’s reserve currency, the potential implications are both subtle and significant.115

Given the opaque nature of central bank operations, it may be that speculation about these issues is all that we will ever have, other than to witness the consequences. Your author’s guess is that the FRB dug itself into something of a political hole, with its confident public announcements throughout 2006–2008 to the effect that there was no credit bubble and the emerging signs of a credit crunch were no problem because FRB monetary policy would take care of everything.116

Undoubtedly the Chair of the FRB has an obligation to sound optimistic in his public pronouncements, as downbeat comments could be self-fulfilling and even spark panic. But as these predictions proved less than stellar, the worldwide credibility of the FRB was affected, to the point that the FRB apparently became duty-bound to address an increasing financial crisis by engaging in extraordinary cooperation with the U.S. Treasury.117 It is not your author’s intention to second-guess the FRB’s response to these significantly unprecedented events, but arguably this became a slippery slope in which defrence to the needs of the U.S. Treasury became increasingly necessary and financially dangerous, even as the joint efforts proved less effective than anticipated (at least as to the overall economy) and thereby engendered even greater monetary stimulus efforts.118

Whatever the explanation, the FRB’s inability to prevent a prolonged economic recession, or the mortgage credit contraction that precipitated it, despite unprecedented inflations of monetary accommodation and the use of multiple funding mechanisms (with all of the attendant risks noted here), placed the FRB in perhaps its most precarious political position ever. One can only feel sympathy: How would you like to be the public figure representing a creature of Congress, responsible for financial regulation and economic prosperity, and answerable to the public, the media, and politicians in Washington, D.C., in this economic environment?119 Perhaps only Tim Geithner has it worse.

N. Pressures for More of the Same

When all of this fails to meet expectations, inevitably pressures will mount for more of the same.120 If the economy fails to recover despite massive increases in federal regulation, monetary accommodation, federal debt, subsidies, bailouts, and spending on TTFB institutions and other favored groups and enterprises, no doubt the lesson announced to the public will be that it was not enough and even more is needed.121 The prospect that the architects, promoters and beneficiaries of these programs will admit that this is the wrong approach, that the problems lie elsewhere (e.g., in a counterproductive legal environment for consumer credit transactions and the resultant fear of unenforceable contracts and legal liability), and that massive federal monetary accommodation, spending, subsidies and bailouts may simply add more economic damage, is nil.


116. Even in the FRB itself contributed to both the credit bubble and the credit contraction. See, e.g., Harrill, supra note 85, at 1212-17 and 1234-37; supra note 9. (Of course, it is not the FRB’s job to save the seeds of panic with pessimistic predictions. See also infra note 149.


119. See supra note 116. As noted here, these problems continue. See, e.g., Blackstone, Lanzaella & Shokin, supra note 98; Weiss, Geithner Gets Credit, Criticism, supra note 88; Weilbrauch, Feud to End New Toning Plan, supra note 38; Selig, Deficit Blamed for Lessons in National Security Threat, supra note 85; G. Glenn Hubbard, Toward a Different Fiscal Future, supra note 40; Review & Outlook, A Double-A U.S.A., supra note 30; Reich, The Necessity of Obamamania, supra note 99; Tom Bartley & Bob Davis, 100 Days: Global Recovery Is Deeper Than Great Depression, April 23, 2009, at S9; and David Enrich, Michael R. Cookston & Mauve Tanzeem, Bank Lending Keeps Dropping, Wall St. J., Apr. 20, 2009, at A1. On the effectiveness of the 2008-2009 federal stimulus efforts, see also Associated Press, Rescues for Unemployed Working, began to disappoint, Oklahoma, July 3, 2010, at A8 (for “double dip”...); Associated Press, Recovery Signs Remain weak, Id. at A8 (for a “fasted at from: almost any angle... from high unemployment to a deteriorating housing market to falling factory orders, the recovery is slowing...”); supra note 2, 4.

120. See supra note 116. As noted here, these problems continue. See, e.g., Blackstone, Lanzaella & Shokin, supra note 98; Weiss, Geithner Gets Credit, Criticism, supra note 88; Weilbrauch, Feud to End New Toning Plan, supra note 38; Selig, Deficit Blamed for Lessons in National Security Threat, supra note 85; G. Glenn Hubbard, Toward a Different Fiscal Future, supra note 40; Review & Outlook, A Double-A U.S.A., supra note 30; Reich, The Necessity of Obamamania, supra note 99; Tom Bartley & Bob Davis, 100 Days: Global Recovery Is Deeper Than Great Depression, April 23, 2009, at S9; and David Enrich, Michael R. Cookston & Mauve Tanzeem, Bank Lending Keeps Dropping, Wall St. J., Apr. 20, 2009, at A1. On the effectiveness of the 2008-2009 federal stimulus efforts, see also Associated Press, Rescues for Unemployed Working, began to disappoint, Oklahoma, July 3, 2010, at A8 (for “double dip”...); Associated Press, Recovery Signs Remain weak, Id. at A8 (for a “fasted at from: almost any angle... from high unemployment to a deteriorating housing market to falling factory orders, the recovery is slowing...”).
IV. But Will It Work?

No one knows for sure the answer to this question, namely: will this massive dose of Keynesian stimulus, bailouts and subsidies, more regulation, and aggressive monetary policies ultimately reignite traditional economic growth? It will finally work, if the government just keeps spending more? If nothing else, there is always the hope that recessions naturally end, as they always have before in our history, seemingly regardless of public policy initiatives. If so, and if traditional economic growth resumes, perhaps aided by government stimulus, the critics may be discredited, and much of the electorate will probably accept the consequences. Results, after all (not theories), are what matter to most people.

But at this writing even the President, Treasury Secretary Geithner, and FRB Chairman Bernanke seem cautious on this point, carefully couching their mandatory optimism with ambiguous phrases like “glimmers of hope,” overcoming “severe stress,” and being “ahead of other countries.” No doubt such equivocation is wise as a general matter, and probably public officials are cognizant of the risks encountered when they and others have exhibited excessive public confidence in the past.

Intuitively, it seems that, at some level, federally-funded stimulus programs that pull all of the apparent economic levers in very large amounts (including massive federal spending; near-zero or effectively negative interest rates; generous federal credit programs; aggressive FRB monetary policy and open market operations; bailouts and subsidies for high-profile enterprises, including insurance and mortgage companies, banks and securities firms, and auto manufacturers; interventions in the securities and capital markets, etc.) must surely have some of the desired effects (beyond mere preservation of the subsidized entities). However, this success is not yet apparent on a broad scale. Moreover, there are basic doubts about a Keynesian model based on the use of federal spending to stimulate aggregate demand (a model that seems to indicate that all federal spending is beneficial, and the more the better). For example, some critics argue that what really matters is where the money comes from, and where it goes.

Experience suggests that the critics have a point, although one may wish that we were as simple as spending our way to prosperity. And one need not be an alarmist to be concerned about the potentially negative impacts of current policies and monetary interventions that are unprecendented in history.
accommodation. It seems obvious that, if the money is taxed or inflated away from productive uses, and spent on unproductive (or less productive) ones, there is a net loss to the economy, not a gain. This will not be cured by turning up the volume. If the money is borrowed in the credit markets, then higher interest rates, some "crowding out" of other (possibly more productive) borrowers, and a future repayment burden are inevitable. There are similar issues with monetary solutions. If the money is simply created by the FRB, absent equivalent increases in productivity or a decrease in velocity, the ultimate result will be inflation.129

All of these scenarios and consequences are detrimental to the general economy and the citizens of the country, i.e., consumers (although, of course, and as noted below, the adverse effects are not uniform or simultaneous). And, obviously, none of this guarantees a broad-based economic recovery.130 Absent such a recovery, only the redistributive effects remain (i.e., some beneficiaries may gain more than they lose, while for others the loss will be far greater).131

A key factor is that in many instances the costs will be diffused and delayed, while the stimulative effects will be targeted and more prompt.132 This offers policy makers a promising means to address immediate issues (and discreetly reward valued constituencies) while deferring any resulting problems until later. In fairness, this probably comports with the wishes of many members of the public, who are naturally focused on next week's paycheck. But it also means that such programs are a race against time, a hope that significant benefits will accrue, soon enough and in sufficient magnitude, to overshadow (and perhaps postpone) the inevitable downside.

On this point the record of the current economic measures is mixed at best, and not entirely promising.133 Clearly it didn't work in 2008, and the results were disappointing in 2009–2010.134 An informal benchmark used by your author, for the lag time after the benefits are received and before adverse consequences begin to appear, is about eighteen to twenty-four months, suggesting that we may begin to experience inflationary and other adverse consequences from the 2008–2009 policies sometime in 2011 (though obviously one cannot be anywhere near as precise on this point).135 But, under almost any scenario, the clock is running, and the prospects for higher taxes and "stagflation" (the dreaded combination of economic stagnation and inflation) in the fairly near future cannot be easily dismissed.136

In the meantime, a surprising number of high-profile enterprises, programs, and market segments remain on federal life-support, essentially dependent on continuing federal spending and accommodative credit and monetary programs for survival.137 If it becomes apparent that these levels of support are both ineffective and unsustainable, the prospect for additional economic shocks cannot be discounted. Calls for even higher levels of stimulus spending and FRB credit expansion are likely,138 but unless the underlying problems in the legal system and the economy are addressed this may only delay the inevitable and ultimately make it worse.

129 See supra note 96–98, supra note 127, Mark Gertler, Aidan H. Anker, The Effects of Unemployment on Wages, Wall Street J., Apr. 19, 2009, at A1. The notion that money is taxed away or inflated away is a common one. See supra note 128. Thus, the alternative to inflation is also not a very promising one. See supra note 122.


131 See supra Part III B. For an interesting take on this issue, see Niskanen & Quigley, Wall Street J., Apr. 14, 2009, at A18, quip by Walter Friedman on the desire of some in the New Deal of the 1930s to focus on redistribution even at the expense of economic recovery. See also Economic Review & Outlook, Missouri State University, Fiscal Policy, Wall Street J., May 25, 2010, at A194. And industry that doesn't get a credit for a loan on hand in the 2007–2008 "fiscal stimulus bill" should have its "lobbying." And also noting that the $100 billion will be paid for by higher costs for the general public. Niskanen & Quigley, id., at A18 (similar effects in international bailouts). See also supra note 122.

132 I am in good company on this point. See e.g., Laffer, supra note 94, supra note 30; see also supra note 100. Obviously, the line is a rough measure, as different policies have different effects. Id.; see also Reich, supra note 127 (arguing that advanced budgetary effects can be quite different in the short term, but will likely have long-term impact on employment for the next decade). Mary Annunziata (in id.). The Weekend interviews with Thomas Healy, The Financial Crisis, Wall Street J., May 16, 2010, at A15; see supra note 127, supra note 94 ("the immediate concern in macroeconomics, or your first graduate course in monetary policy, you learn that monetary policy acts with long and variable lags."). Compare supra notes 127–129.

133 See supra note 96–98, supra note 127, Mark Gertler, Aidan H. Anker, The Effects of Unemployment on Wages, Wall Street J., Apr. 19, 2009, at A1. The notion that money is taxed away or inflated away is a common one. See supra note 128. Thus, the alternative to inflation is also not a very promising one. See supra note 122.

134 See supra note 96–98, supra note 127, Mark Gertler, Aidan H. Anker, The Effects of Unemployment on Wages, Wall Street J., Apr. 19, 2009, at A1. The notion that money is taxed away or inflated away is a common one. See supra note 128. Thus, the alternative to inflation is also not a very promising one. See supra note 122.

135 This was apparently the hope of the 2008–2009 stimuli and bailouts, which it is predicted will become in time. See e.g., Michael Cooper, Obama's Home Runs in Building Wall Street's Rainy Day Fund, Wall Street J., Apr. 16, 2010, at A13, supra notes 125–131, supra Part III B, supra note 98.

136 See supra notes 2, 97–98, 120–121, and 127–128. There is a general consensus that the 2009 financial reform legislation will further constrain credit availability and raise its costs. See supra note 4, Sidney Reddick, Consumer Agency, Wall Street J., June 6, 2010, at A14 (noting Publix University Professor of Law Kathleen Engard: "Credit is going to be a little more expensive... that I think you should use credit wisely and carefully...""). The article also notes that "infantile consumer advocates acknowledge that certain borrowers — particularly, low-income consumers — are likely to find less credit available as credit standards are regulated more closely..." Whether you think this will be good or bad may depend on whether you are one of the cut off from your customary sources of credit. See generally supra notes 147 and 156.

137 See supra notes 2, 97–98, 120–121, and 127–128. There is a general consensus that the 2009 financial reform legislation will further constrain credit availability and raise its costs. See supra note 4, Sidney Reddick, Consumer Agency, Wall Street J., June 6, 2010, at A14 (noting Publix University Professor of Law Kathleen Engard: "Credit is going to be a little more expensive... that I think you should use credit wisely and carefully...""). The article also notes that "infantile consumer advocates acknowledge that certain borrowers — particularly, low-income consumers — are likely to find less credit available as credit standards are regulated more closely..." Whether you think this will be good or bad may depend on whether you are one of the cut off from your customary sources of credit. See generally supra notes 147 and 156.

138 See supra note 96–98, supra note 127, Mark Gertler, Aidan H. Anker, The Effects of Unemployment on Wages, Wall Street J., Apr. 19, 2009, at A1. The notion that money is taxed away or inflated away is a common one. See supra note 128. Thus, the alternative to inflation is also not a very promising one. See supra note 122.

139 See supra Part III B. For an interesting take on this issue, see Niskanen & Quigley, Wall Street J., Apr. 14, 2009, at A18, quip by Walter Friedman on the desire of some in the New Deal of the 1930s to focus on redistribution even at the expense of economic recovery. See also Economic Review & Outlook, Missouri State University, Fiscal Policy, Wall Street J., May 25, 2010, at A194. And industry that doesn't get a credit for a loan on hand in the 2007–2008 "fiscal stimulus bill" should have its "lobbying." And also noting that the $100 billion will be paid for by higher costs for the general public. Niskanen & Quigley, id., at A18 (similar effects in international bailouts). See also supra note 122.
If, as suggested here, a significant problem in the economy and credit markets is the legal barriers to origination and enforcement of consumer credit transactions (particularly subprime mortgage loans) that have been erected over the past decade (a trend that has accelerated since 2006, a period that coincides with the current credit contraction), the current solutions are not likely to be effective. Given the economic importance of mortgage credit and consumer spending, it is not surprising that the resulting credit contraction has hit the economy hard; the hoped-for stimulative effects of Keynesian spending and FRB monetary policy have run into a continuing credit system bottleneck and as a result are less effective than in the past (which itself provides only a spotty record of success). In these circumstances, the continuing emphasis on federal spending, regulation, and subsidized credit programs may be ineffective or even counterproductive, increasing the adverse consequences more rapidly than any marginal benefits that accrue. Economic and financial analyses based on a static legal environment may not accurately account for these new legal realities; in effect, the past may no longer be prologue. And to the extent this encourages a continuation, repetition, or even expansion of harmful policy errors, a new and continuing cycle of similar (or worse) problems can be expected.

V. Alternative Solutions

This article focuses on the likely outcome of current policies, on the theory that they are not susceptible to significant change and therefore will require accommodation, rather than seeking to advocate alternatives, but perhaps at least a short note on the latter is in order. Unfortunately, there is no simple, politically-appealing solution. The obvious solution is to rationalize the structure of consumer credit law, returning to a state common law model with reasonable and sustainable consumer protections, while utilizing the uniform law process to provide national uniformity and remove unnecessary impediments to market entry, competition, and credit availability. This is a faint hope, given the political dynamics that led to the current legal environment. Many of the policy initiatives implemented in the past five years are blatantly counterproductive, and a good start would be to revisit (or repeal) them, but as suggested here and elsewhere the problems go back even further. This suggests the need for a comprehensive, long-term solution, and recognizes the difficulty of achieving such.

As noted, an obvious prospect is the uniform law process, which probably offers the best hope for a more informed, less emotive drafting process as compared to more politically-charged state and federal legislative efforts. There are periodic efforts to move in this direction, and they may yet succeed, but it is by no means certain that even this approach could succeed as to such highly contentious issues. Given the highly-charged political atmosphere surrounding these issues, there is every prospect that the same interests that have brought us to this point will continue to dominate the discourse, even in the context of drafting a uniform state law.

Perhaps, then, the best prospect, as usual, is recourse to the residual common law foundations of state law. An important feature of our federalist system is that it allows individual states to be laboratories for legal experimentation, for better or for worse. Just as some states have responded to the bursting of the housing bubble by making things worse, other states have restrained these influences and maintain a more rational legal environment. In the latter states, the basic rule of law and the common law structure of property and contract rights remain largely intact, allowing limited private funding to flow around the edges of an increasingly federalized consumer finance system. These traditional transactions are much reduced in number and scope, by reason of federal restrictions and some state and local laws. But, so
long as a basic system of state common law remains intact, creative legal minds and financial engineers will seek to devise lawful ways to serve the needs of consumers within that system. For now, at least in some states, that is the best hope for many consumers.

VI. Conclusion

Various commentators and public officials have both cast and received blame for failures to predict or prevent the credit contraction and economic recession, but efforts to assign individual blame are largely disingenuous. Strange things were happening when this began in 2006-2007: some states and federal regulators (and some members of Congress) were doing all they could to "crack down" on (and thereby reduce) subprime mortgage lending, by various measures essentially designed to restrict the availability of such credit. Congress became actively interested in this issue, with adverse consequences, and threatened even worse, a phenomenon that continues to this day. Perhaps one must be attuned to operational and underwriting considerations in consumer financial services transactions to comprehend the consequences of such measures. In any event, in 2006-2007 creditors and investors began to realize that the legal climate for mortgage credit was changing in important and adverse ways. Predictably, as this realization spread, mortgage lending (and housing prices) collapsed, in the face of a public policy onslaught against the subprime lending transactions that so many consumers depended upon. As subprime mortgage lending came to a halt in many areas, related consumer spending (the underpinning for an economic boom) soon followed. Of course the boom ended—what else could anyone expect?

Throughout much of this period, while the FRB was acceding to Congressional and media demands for new regulations to curtail subprime lending, the FRB was also swimming against this tide by seeking to promote credit availability with a strongly expansionary monetary policy. The FRB reduced interest rates to extraordinarily low levels and (through open market operations and institutional lending initiatives) has pumped enormous liquidity into the financial system, encouraging excessive speculation in selected markets.

With a legal bottleneck clogging the mortgage markets, in the form of onerous laws and regulations (and for even more of the same), and increasing creditor and investor fears over the enforceability of consumer credit contracts in this new legal environment, there has been nowhere else for the new liquidity bubble to go but other financial markets, including commodities, gold, and stocks (and U.S. government-backed securities).

Thus, from 2006 through early 2008, low interest rates, rising stock markets and strong commodities prices were masking the emerging problems in the credit markets and economy, sending false signals that indicated to many observers that everything was okay. Apparently it takes an understanding of consumer credit laws, transactions, and markets to recognize that all is not well in these circumstances, and to anticipate emerging problems in the midst of a seemingly ideal combination of low interest rates, rising stock markets and commodity prices, and generous federal spending.

Then, as now, FRB monetary policy was a key ingredient, and was intended to be, the apparent theory being that FRB policy can fix almost anything: If the FRB can pump enough money into the system to maintain high stock market prices, bank liquidity, and low U.S. Treasury yields (where else would prudent money go?), this will bolster public confidence because the public is not attuned to any other financial indicator.

This encourages consumers to continue their normal spending behavior, avoiding reactions that might create or contribute to the crisis. These stimulative efforts (which continue, with similar results, to this day) would have been heralded as genius had they worked in 2008, but in the event these efforts merely masked the economic realities created by legal problems and policy errors, and probably misled many unruly creditors and investors (and television commentators).


149. In the fall of 2008, in the face of the stock market crash, Fox News personality Bill O'Reilly publicly criticized then President Bush for "not caring" in advance of the impending crash. But of course this was the President's job, and he had tried to do so but he could have been denounced for providing otherwise acceptable problems. See supra note 161 (noting that it is likewise not the job of the Hill to do this). See also infra note 154.

150. See, e.g., supra notes 2, 4, and 10; Harrell, supra note 138. Although too much credit had been available, somewhat commonly held, and much public policy was directed at restricting the supply of credit, warnings that this could impinge the mortgage credit system and national economy were intentionally ignored by policy makers. To this day, policy makers and the news media are ridiculously unaware of what caused this crash.


152. Mark Bittner, Mortgage, Home Depreciation, Mortgage, Wall St. J., July 2, 2010, at A1 (stating interest demand for "mortgage bonds backed by the U.S. government as a safe haven"). See also infra note 153 and 1. This enables the banks that finance this lending to generate large processing and trading profits and interest rate margins, bolstering their balance sheets, and helping drive a stock market boom. The benefits to the general public are less clear. See, e.g., Michael Cooper, supra note 127, supra note 153, supra notes 162 and 3; see also supra note 4. See also supra note 4; John C. McMahon, The High Cost of Very Low Interest Rates, Wall St. J., Aug. 17, 2010, at D5.

153. Anyone who expressed concern during this period, about the economy’s ability to generate new credit, was likely to be treated with disdain by some of those who insist that every new regulatory authority is all that is needed to allow authorities to predict and prevent such problems.

154. Id.
The FRB’s split personality on these issues (no doubt reflecting the pressures of Congress and the divided government in Washington, D.C. at the time) helped create an unusual legal and economic environment, in which foundational consumer credit transactions (e.g., subprime mortgage lending) were being strangled by new laws and regulations at the same time that popular economic indicators such as low interest rates and rising stock markets were pointing to renewed prosperity.26 No wonder so many borrowers, creditors, investors and commentators were misled and confused.259

No one wants to be a naysayer, and in the past the basic strengths of the American common law and federalist system have ultimately overcome any obstacles placed in the path of economic recovery. But traditional economic and financial analyses depend upon “other things being equal” (ceteris paribus); this time they are not. As a result, economic models predicting that a traditional, “V-shaped” recovery is right around the corner may no longer be reliable.260 This time, literally, the rules have changed, not just for borrowers, creditors, investors and commentators, but for policy makers and the American economy, and indeed the world.

156. See supra note 2. As noted, it is a public policy dictionary that continues today, as Congress and some states pursue even more stringent restrictions on private credit, while the U.S. Treasury and FRB seek desperately to resuscitate the credit markets. See, e.g., id.; Money & Markets, Arr Enr. Check, Oklahoman, April 17, 2009, at 5B (“The [FRB is] buying mortgage-backed securities and long-term debt, which is helping to push down interest rates.”); Robert DeYoung, Congress Takes Aim at Payday Loans, Wall Str. J., April 14th, 2009, at A13; Review of Outlook: An Other Banks Can Rejoin, Wall Str. J., April 10, 2009, at A1; Kenneth Hersey, Lenders Prepare to Reform Mortgage Lending, Oklahoma, April 11, 2009, at 26; Peter Lattman, Jenny Strasburg & Deborah Solomon, Foreign Asset Plan Needs Steve’s Nod, Wall Str J., Mar. 24, 2009, at A4 (describing the $1 trillion federal plan to buy up assets “that are choking the flow of credit.”). See also supra notes 2, 4, 9, 13, 14 and 17.

157. (Continued from previous column)

... astounding is that essentially all housing credit is [already] controlled by the government. “Somehow,” between 80 and 95 percent of all the residential mortgages this year have been insured by, guaranteed by or securitized by the government.” One might think that someone at the FRB, or in Congress, or in the Treasury administration, or the mainstream media, might wonder why private mortgage credit has suddenly all but disappeared, despite unprecedented monetary and fiscal stimulus, subsidies and bailouts. Apparently it is beyond such comprehension that public policy may have succeeded too well in rescuing private subprime mortgage credit. See, e.g., Elizabeth Warren, Rescuing the Regulators Affecting Business, Wall Str. J., July 12, 2010, at A4 (citing efforts of the administration to address regulations that are obstacles to private investment, and listing many examples—consumer credit regulations is conspicuously absent from considerations). The Dodd-Frank Act obviously will make things even worse. See, e.g., Review & Outlook: The Certainty Principle, Wall Str. J., July 14, 2010, at A18 (“Whatever else this will do, it will not make lending cheaper or credit more readily available.”); McHenry Tribune Information Services, Wells Fargo Plans to lay off 3,360 and non-prime mortgage, Oklahoma, July 17, 2010, at SF (citing the reason: “Not prime products are going to be in the bullseye of the target of the FDIC.”)

158. See, e.g., Janna Luttrell, Top 10 Franchisees: See Real Times, Wall Str. J., Jan. 5, 2011, at 36 (offering five tips to small business owners on how to avoid the recession); supra note 137; Kathleen Lynn, Red Forest, Housing market woes prompt research, Oklahoma, July 17, 2010, at SF (quoting Nicki 12th Quarter of the report’s conclusions). This report was prepared by the board for 2009,8 assuming the recovery of the recession.”)


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