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2010

# The Great Credit Contraction: Who, What, When, Where and Why

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# THE GREAT CREDIT CONTRACTION: WHO, WHAT, WHEN, WHERE AND WHY

Alvin C. Harrell\*

## INTRODUCTION

By now nearly everyone knows that the heart of the current problems in our economy is too little credit, not too much.<sup>1</sup> A salient feature of our current economic crisis is the transition from the credit boom years of 1993–2006, to the credit bust beginning in roughly 2007 and continuing to the present, a period referred to here as the “Great Credit Contraction.”<sup>2</sup> This stands in contrast to much of the

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1. See Michael R. Crittenden & Marshall Eckblad, *Lending Falls at Epic Pace*, WALL ST. J., Feb. 24, 2010 at A1; S. Mitra Kalita, *Beyond the Bubble: The ‘Democratization of Credit’ Is Over—Now It’s Payback Time*, WALL ST. J., Oct. 10, 2009, at A1; David Streitfeld, *Rates Are Low, But Banks Balk at Refinancing*, N.Y. TIMES, Dec. 13, 2009; Nick Timiraos, *Borrowers Pass Up Mortgage Windfall*, WALL ST. J., Mar. 3, 2010, at A1. Importantly, this has not prevented the advancement of legislation and regulation designed to reduce credit availability even further. See, e.g., Alvin C. Harrell, *Commentary, The Proposed Consumer Financial Protection Agency Act*, 63 CONSUMER FIN. L.Q. REP. 140 (2009); *infra* Parts II and III.

2. See Kalita, *supra* note 1. Some have referred to it as The Great Recession. See Justin Lahart, *Currents, The Great Recession: A Downturn Sized Up—Unemployment Lines Have Been Long Before, but No Prior Slump Since World War II Has Hurt So Much on So Many Fronts*, WALL ST. J., July 28, 2009, at A12; Mortimer Zuckerman, *The Great Recession Continues*, WALL ST. J., Jan. 22, 2010, at A19. At this point, some have also declared the recession over, but to others that seems overly optimistic. See Associated Press, *At Last the Recession Is Over—What Now?*, OKLAHOMAN, Oct. 30, 2009, at 3B; Associated Press, *Higher Jobless Rates Could Be New Normal*, OKLAHOMAN, Oct. 20, 2009, at B1; Stephanie Armour, *Foreclosures Break Record*, USA TODAY, July 16, 2009, at 3B; Alan S. Blinder, *The Economy Has Hit Bottom*, WALL ST. J., July 24, 2009, at A15 (noting that the bottom of a recession is not the same as a recovery); Jon Hilsenrath & Deborah Solomon, *Job Cuts Outpace GDP Fall—Break from Historical Pattern Suggests That Unemployment Could Weigh on Recovery*, WALL ST. J., July 23, 2009, at A3; Jim Kuhnhehn, *Jobless Rate Becomes Obama’s New Reality*, OKLAHOMAN, Nov. 7, 2009, at 3C (“At 10.2 percent . . . unemployment [has] climbed to chart-topping heights unseen in more than a quarter century . . . [M]ore than 15 million Americans are out of work and 3.5 million lost their jobs while Obama was president.”); Amy Merrick & Conor Dougherty, *Plunging Revenue Squeezes State Budgets Further*, WALL ST. J., July 17, 2009, at A3; Sudeep Reddy, *Bernanke Sees Slow Recovery as Skittish Consumers Cut Back*, WALL ST. J., July 23, 2009, at A2; see also Ruth Simon, *Foreclosure Rescue Still Bugged Down*, WALL ST. J., Dec. 11, 2009, at A9; *The Year in Foreclosures*, N.Y. TIMES, Feb. 15, 2010, at A20 (noting that the foreclosure crisis continues “[e]ven with broad government support for housing . . .”). Clearly, something has gone awry. See, e.g., Associated Press, *Stimulus-Related Jobs Don’t Add Up in Report*, OKLAHOMAN, Oct. 29, 2009, at 3B; Liam Denning, *U.S.’s Grossly Distorted Product*, WALL ST. J., Oct. 30, 2009, at C10; David Enrich & Dan Fitzpatrick,

academic commentary and public policy initiatives of recent years, which often have focused on the need to restrain credit availability.<sup>3</sup> The result is a disconnect between public policy and economic needs that is contributing to the crisis. This article explores this disconnect in the context of the Great Credit Contraction, including the relation between consumer protection law, credit availability, and economic growth (or recession), with consideration given to the ways that misguided legal initiatives may have unintended consequences which contribute to economic volatility and distress.

This article seeks to avoid two analytical weaknesses that seem prevalent in the literature on these issues. One is essentially a lack of analysis—a tendency to describe what happened without explaining how or why. More than one presentation and article have been billed

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*Loans Shrink as Fear Lingers—Portfolios at Big Banks Fall 2.8% in Last Quarter*, WALL ST. J., July 27, 2009, at A1; Edward P. Lazear, *Stimulus and the Jobless Recovery*, WALL ST. J., Nov. 2, 2009, at A19; Don Mecoy, *Economist Calls Recovery 'Half-Baked'*, OKLAHOMAN, Feb. 24, 2010, at 4B; Sara Murray, *As Retail Sales Climb, Consumers Stay Glum*, WALL ST. J., Feb. 13, 2010, at A2 (noting decline in the consumer-sentiment index); Peggy Noonan, *Declarations, We're Governed by Callous Children*, WALL ST. J., Oct. 31, 2009, at A19 (“[N]o one has any faith in [the government] numbers.”); Liz Rappaport & Serena Ng, *Lending Squeeze Drags On*, WALL ST. J., Dec. 8, 2009, at A1; see also Mortimer Zuckerman, Op-Ed., *The Economy Is Even Worse Than You Think*, WALL ST. J., July 14, 2009, at A13; Streitfeld, *supra* note 1. As noted in this article, among the reasons for these problems is the Great Credit Contraction.

3. See Kurt Eggert, *The Great Collapse: How Securitization Caused the Subprime Meltdown*, 41 CONN. L. REV. 1257 (2009). Compare Harrell, *supra* note 1, with Todd Zywicki, *Complex Loans Didn't Cause the Financial Crisis*, WALL ST. J., Feb. 19, 2010, at A15. For examples of recent legislation and regulatory initiatives that discourage the availability of consumer credit, see *id.*; Richard E. Gottlieb & Andrew J. McGuinness, *Subprime Lending as a Public Nuisance: Casting Blame Mortgage on Lenders and Wall Street for Inner City Blight*, 62 CONSUMER FIN. L.Q. REP. 4 (2008); Stephen F.J. Ornstein et al., *The Current Residential Mortgage Market Landscape in the United States*, 61 CONSUMER FIN. L.Q. REP. 891 (2007); Janet Frank, *Summary of Banking Regulatory Guidelines for Home Mortgage Lending*, 61 CONSUMER FIN. L.Q. REP. 154 (2007); *infra* Part I.B.7. See also Gary Fields, *Vermont Mortgage Laws Shut the Door on Bust and Boom*, WALL ST. J., Aug. 18, 2009, at A1 (noting that Vermont's strict consumer protection laws “[keep] some Vermonters . . . from buying homes.”). The restraints on private credit have continued to increase even as direct federal credit subsidies have increased, creating a split personality in credit policy that discourages private credit availability even as public funding has increased. See *infra* Parts II–III; Editorial, *The Fannie Mae Dice Roll Continues*, WALL ST. J., Nov. 11, 2009, at A20 (describing federal subsidies for residential mortgage credit); Henry Kaufman, *The Real Threat to Fed Independence*, WALL ST. J., Nov. 11, 2009, at A21 (noting the recent increase in the Federal Reserve Board's balance sheet to \$2.2 trillion, including more than \$1 trillion of long-term mortgage-related securities). Not surprisingly, this has resulted in the effective nationalization of the mortgage finance industry, with roughly 90% of mortgage lending being funded by the federal government and the private mortgage market “all but erased.” *The Fannie Mae Dice Roll Continues*, *supra*; see also, Peter Eavis, *Uncle Sam Bets the House on Mortgages*, WALL ST. J., Sept. 18, 2009, at C2; *infra* Parts II–III.

in essence as explaining how and why the current credit crisis happened, only to present a factual recitation of the relevant events (Lehman Brothers failed, private credit declined, housing values collapsed, foreclosures soared, etc.) without any explanation of the cause and effect relationships responsible for those events. Yet, absent an understanding of these causes and effects, the analysis is obviously incomplete, and any policy recommendations and responses may be merely band-aids that describe the symptoms without addressing needed reforms.

Another analytical weakness, hopefully avoided here, is the tendency to blame the messenger: to blame contract law for bad economic decisions. Contract law merely allows parties to enter into voluntary economic transactions. Given that voluntary transactions are based on individual assessments of needs and wants, and expectations about the future, which may prove wrong, it is inevitable that some such transactions will go awry. This is even more likely in periods of economic volatility, for example, when an economic boom turns to bust. But contract law does not encourage parties to make bad decisions (that honor belongs elsewhere, as noted below). It is an over-simplification—and an inadequate explanation—to say that the parties made a bad deal because contract law allowed them to do so. This is not to say that contract law should be outside the analysis;<sup>4</sup> but, if this is where the analysis stops, it will be decidedly incomplete and may lead to a preordained conclusion that is inconsistent with party autonomy and American legal traditions. Because contract law is both the mechanism for and the measure of wealth creation,<sup>5</sup> the

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4. The role securitization played in this crisis has previously been noted. Alvin C. Harrell, Commentary, *The Subprime Lending Crisis—the Perfect Credit Storm?*, 61 CONSUMER FIN. L.Q. REP. 626 (2007); see also *infra* Part I.B.5.

5. As well as being essential to our Constitutional right to the pursuit of happiness. See U.S. CONST. amend. XIV; *Meyer v. Nebraska*, 262 U.S. 390 (1923); *Kay v. Clear Channel Commc'ns*, No. 03-6647, 2005 WL 2683075 (E.D. Pa. Aug. 19, 2005) (mem.). Obviously, beyond basic barter transactions, contracts are necessary to enable consumers to enter voluntary transactions to maximize their well-being, i.e., to exchange things they have (including time and effort) for other things they want more. See RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 27–100 (2d ed. 1977). If private parties are precluded from such exchanges, the economy as well as the parties suffer. *Id.* at 271–286 (addressing the issue of market failure); Fields, *supra* note 3. For example, if consumers cannot get credit, they cannot buy as much, and economic activity will decline. Money, in turn, serves as the contractual measure of value for parties in such transactions (i.e., an accounting unit and medium of exchange, but

result may be public policies that unduly discourage private transactions and impair economic growth. This is precisely the scenario described below.

## I. WHAT HAPPENED (AND WHY)—THE STORY OF THE GREAT CREDIT CONTRACTION

### A. *Background—Credit Bubbles*

History (and certainly American history) has been characterized by the ebb and flow of credit availability, coincident with economic boom and bust cycles.<sup>6</sup> Credit expansions and contractions feed on themselves and are often unintentionally reinforced by public policy responses,<sup>7</sup> and therefore may seem to take on lives of their own; however, legitimate credit, being dependent on law, always requires certain basic societal elements to flourish, for example, a stable political, monetary, and legal environment. Absent these elements, widespread private credit will not exist; with them, it will.<sup>8</sup> With the unique American foundation of Constitutional federalism and state common law patterned on British traditions, including party autonomy, limited government, due process, and an independent judiciary, and (in the late Twentieth Century) legal reforms such as

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only if it can also serve as a reasonable store of value). JAMES D. GWARTNEY, *ECONOMICS: PRIVATE AND PUBLIC CHOICE* 184–85 (1976). Laws and policies that impair these basic functions are obviously counterproductive.

6. Assisted by what some have called a tendency toward “collective hallucination.” See, e.g., Lee Gomes, *Digital Tools, All Aboard the Bubble Express*, *FORBES*, Mar. 15, 2010, at 34; see also Mark Frankel, *When the Tulip Bubble Burst*, *BUS. WK.*, April 24, 2000, available at [http://www.businessweek.com/2000/00\\_17/b3678084.htm](http://www.businessweek.com/2000/00_17/b3678084.htm) (reviewing MIKE DASH, *TULIPOMANIA, THE STORY OF THE WORLD’S MOST COVETED FLOWER AND THE EXTRAORDINARY PASSIONS IT AROUSED* (2d ed. 2000)).

7. See sources cited *supra* note 5. An obvious public policy example is the efforts, in the face of massive foreclosure losses for creditors and investors, and declining credit availability for consumers, to make the enforcement of contracts and mortgage liens even more difficult and expensive. See generally Symposium, *Debt Collection, Mortgage Law, and Foreclosure*, 63 *CONSUMER FIN. L.Q. REP.* 221 (2009); sources cited *infra* note 28.

8. See sources cited *supra* note 5. Probably we do not need behavioral economists to tell us that people enjoy consumption; given the opportunity, they like to borrow money and buy things. See, e.g., Laurie A. Burlingame, *Getting to the Truth of the Matter: Revising the TILA Credit Card Disclosure Scheme to Better Protect Consumers*, 61 *CONSUMER FIN. L.Q. REP.* 308, 329–331 (2007) (noting behavioral economic studies of consumer behavior that reflect this trait).

enactment of the Uniform Commercial Code and the end of unrealistic usury statutes, there was an unprecedented convergence of the required elements that helped to create a fifty year credit and economic boom. In the early part of the Twenty-First Century this began to unravel, for the reasons noted below.

Throughout this roughly fifty year credit expansion, of course, there continued to be economic ups and downs, and tensions between the advocates and opponents of expanded credit availability, reflecting in part the conflicting needs to protect both party autonomy and vulnerable consumers. These tensions resulted in political compromises such as the Truth in Lending Act,<sup>9</sup> other measures designed to restrict various classes of consumer debt,<sup>10</sup> and still other measures designed to increase the availability of credit for specified types of transactions and classes of consumers.<sup>11</sup> Facilitated by an accommodative Federal Reserve Board (FRB) monetary policy and a global economic boom that created economic conditions favoring investment flows into financial asset securitization,<sup>12</sup> efforts to expand housing credit became a primary focus of government policy beginning in the early 1990s, resulting in an unusual, if not unprecedented, nearly fifteen year housing and credit boom, commencing in roughly 1993.<sup>13</sup>

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9. Truth in Lending Act, 15 U.S.C. §§ 1601–1666j (2006).

10. See, e.g., FTC Credit Practices Rule, 16 C.F.R. § 444.1 (2009).

11. See, e.g., Equal Credit Opportunity Act, 15 U.S.C. § 1691(2006); Community Reinvestment Act, 12 U.S.C. § 2109 (2006); see *infra* Part I.B.4.

12. See discussion *infra*. Among other things, the U.S. credit and housing boom of 1993–2006 dramatically increased imports and created large dollar balances abroad, in turn creating a global demand for securitized financial assets as a reinvestment vehicle.

13. See, e.g., Vernon L. Smith, *The Clinton Housing Bubble*, WALL ST. J., Dec. 18, 2007, at A20; *infra* Part I.B.4. For most of the post-World War II period, there were multiple economic cycles (including credit and housing cycles) each decade. See, e.g., Donald C. Lampe, Fred H. Miller & Alvin C. Harrell, *Introduction to the 2008 Annual Survey of Consumer Financial Services Law*, 63 BUS. LAW. 561, 562–63 (2008) (citing various sources). The 1993–2006 cycle was unusually long in comparison. *Id.*

## *B. The Credit and Housing Boom of 1993–2006—How It Happened*

### *1. Introduction*

As suggested above and discussed further below,<sup>14</sup> some of the antecedents to the 1993–2006 credit and housing boom go back at least to 1977, when the Community Reinvestment Act (CRA) was enacted, and perhaps even 1969, when the Equal Credit Opportunity Act (ECOA) was enacted. But, despite some previews in the 1970s and 1980s, decades marked by their own credit and housing booms and busts,<sup>15</sup> the mother of all credit and housing booms had to await the other, related developments that began in the early 1990s; as noted below at Parts I.B.2–6. These developments set the stage for the Great Credit Contraction that began in 2007.

### *2. The FRB*

The first of these developments, and the most easily identifiable factor contributing to the crisis, was FRB monetary policy, which turned unusually accommodative in the early 1990s and remained so for nearly fifteen years thereafter. More than any other factor, this explains why credit expanded and asset prices exploded over this period.

While in hindsight this is easy to criticize, it was not an irrational policy posture, though it turned out to be ill-advised. In the early 1990s the condition of the banking system and the Federal Deposit Insurance Corporation (FDIC) was in question, and there were concerns—in the wake of the previous housing and credit collapse of the late 1980s and early 1990s—that the banking system would follow much of the thrift industry into insolvency.<sup>16</sup> The FRB kept

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14. See *supra* notes 10–11; *infra* Part I.B.4.

15. See, e.g., Alvin C. Harrell, *Penn Square Bank—20 Years Later: Introduction to the Symposium*, 27 OKLA. CITY U. L. REV. 945 (2002).

16. See *infra* note 17. These same types of risks remain a concern today. Compare Michael M. Phillips, *America's Newest Land Baron: FDIC*, WALL ST. J., Nov. 17, 2009, at A1 (noting the state of the FDIC fund), and David Enrich, *TARP Can't Save Some Banks*, WALL ST. J., Nov. 17, 2009, at C1 (noting financial problems in the banking industry); and Peter J. Wallison, *The Permanent TARP*, WALL ST. J., Nov. 17, 2009, at A25 (same), with KANE, *infra* note 17, at 1–18 (similar issues in late 1980s).

interest rates high throughout the thrift crises of the 1980s,<sup>17</sup> unwilling to sacrifice monetary stability to save the thrifts, which, after all, were someone else's responsibility. But when the resulting recession threatened to drag down the banks, the FRB took a different stance.

Thus, beginning in 1993 the FRB took its foot off the brakes and stomped on the monetary accelerator. Together with a more lenient bank regulatory stance during the Clinton presidency (at least regarding credit standards),<sup>18</sup> and ultimately the fiscal stimulus of the significant tax reductions pushed by a Republican-controlled Congress, these measures had the desired effect: credit and the economy began to boom again. Asset prices surged; the banks—and the FDIC—were saved.

No doubt (then, as now) the FRB intended to take its foot off of the accelerator as soon as the economy got moving again. No one would suggest that the monetary authorities intentionally pushed too hard, or for too long. But as usual unforeseen events intervened, including a series of new crises, including: the bursting of the dot.com bubble; the Russian debt crisis; a major hedge fund collapse; Y2K; the 9-11 attacks; the Asian currency crisis; Enron and other major bankruptcies;<sup>19</sup> various election cycles (one can't raise interest rates in an election year, now, can one?<sup>20</sup>); and the need to fund various wars and federal programs. All of these created needs for urgent

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17. For sources noting the devastating impact of high interest rates on the thrift industry in the 1980s, see, e.g., George Sutton, *Penn Square Bank—20 Years Later: A Personal Recollection of the Causes and Effects of the Banking and Deposit Insurance Crisis of the 1980s*, 27 OKLA. CITY U. L. REV. 969, 972–73 (2002); Alvin C. Harrell, *Deposit Insurance Issues and the Implications for the Structure of the American Financial System*, 18 OKLA. CITY U. L. REV. 179, 186–89; JAMES R. BARTH, *THE GREAT SAVINGS AND LOAN DEBACLE* 37–40 (1991); EDWARD J. KANE, *THE S & L INSURANCE MESS* 72–75 (1989).

18. See, e.g., Smith, *supra* note 13. This was a stance that directly favored a credit expansion: leniency on credit standards, coupled with vigorous enforcement of the CRA and fair lending requirements. See, e.g., *infra* Part I.B.4.

19. The political responses often led to yet another crisis. See, e.g., Norwood P. Beveridge, *The Federalization of Corporate Law*, 60 CONSUMER FIN. L.Q. REP. 18 (2006); Lampe, Miller & Harrell, *supra* note 13.

20. For one thing, that might make the FRB a political issue, like the way energy companies are treated when the world-wide price of oil rises. Truly, this is better avoided. Still, the FRB has hardly escaped criticism. See *infra* note 28.



monetary measures to forestall the potential for a spreading economic crisis.

The FRB got us through all of this with nary a scratch, and was widely acclaimed for doing so. Moreover, the FRB is a creature of (and answers to) Congress, and Congress loves low interest rates, expanded home ownership, increasing asset prices, and widespread credit availability. The CRA and ECOA reflect Congressional mandates for this state of affairs,<sup>21</sup> and the federal banking regulators got the message; then there was a heavily subsidized and aggressively expanding Fannie Mae and Freddie Mac.<sup>22</sup> In all, the credit and housing boom of 1993–2006 was a fine party and the FRB kept the punchbowl full. Who would want to be a naysayer and swim against this tide?

There was only one fundamental problem. Inevitably, the housing and credit boom turned into a bubble. Now, a point that is suitable for emphasis here is that no one can actually tell when this is happening, only perhaps in retrospect.<sup>23</sup> Anyone who tried to warn of the dangers during this boom was (as usual) left in the dust as asset prices seemed destined to accelerate forever.<sup>24</sup> Few wanted it to end.<sup>25</sup>

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21. See *infra* Part I.B.4. See also Richard W. Fisher, *Congress is Politicizing the Fed*, WALL ST. J., Jan. 26, 2010, at A17.

22. See *infra* Part I.B.3.

23. Indeed, it should be noted that, if monetary authorities are allowed to create a continuous currency devaluation and inflationary spiral, the asset boom may never end, at least as measured in terms of monetary valuation. In this scenario, anyone who tries to stand in the way by betting against a continuation of the bubble is at risk of being financially trampled. See, e.g., Associated Press, *Investors See Gold Upsurge as Shield Against Dollar*, OKLAHOMAN, Nov. 12, 2009, at 1B (noting the risks of depreciating currencies). Obviously, this implicates even more serious issues. See, e.g., *supra* note 5.

24. *Id.*

25. Again (see *supra* note 16), one should not be too critical; in this respect, all asset bubbles are the same—including the current one. See Associated Press, *supra* note 23; Business Briefs, *Fed Watches for New Bubble*, OKLAHOMAN, Nov. 25, 2009, at 3B; E.S. Browning, *For Stock Investors, Bad Economy Isn't Bad*, WALL ST. J., Nov. 9, 2009, at C1; Carolyn Cui & Andrea Hotter, *Commodities Report, Copper Rises Despite the Stockpiles*, WALL ST. J., Nov. 23, 2009, at C5 (noting that the price of copper more than doubled last year, even as inventories swelled); Liam Denning, *U.S.'s Grossly Distorted Product*, WALL ST. J., Oct. 30, 2009, at C10 (“Washington provides tax breaks to first-time buyers, guarantees most of the mortgages written, and then buys most of those . . . suggest[ing] a worrying case of amnesia following the bursting of the housing bubble.”); Andy Kessler, *The Bernanke Market*, WALL ST. J., July 15, 2009, at A15 (“Ben Bernanke has been the market.”); George Melloan, *We're All Keynesians Again*, WALL ST. J., Jan. 13, 2009, at A17 (“[T]he Bernanke [FRB] seems to believe the way to deal with a collapsed bubble is to reflate it.”); Mark Whitehouse, Scott Kilman & Alex Frangos, *Commodity-Cost Jump Threatens to Stifle Rebound*, WALL ST. J., Jan. 9, 2010, at A4; see also Brian

Certainly consumers did not want it to end—they wanted to participate. Today, much of the talk focuses on how unscrupulous lenders and mortgage brokers suckered hapless consumers into making unwise decisions (how wonderful it is to have hindsight), but during the boom it appeared to be free money.<sup>26</sup> With the FRB maintaining interest rates at levels near zero, Fannie and Freddie pushing mortgage loan rates nearly as low, and housing prices surging, it seemed that only a fool would decline to borrow money to take advantage of rapidly rising property markets.<sup>27</sup> Consumers did not need to be enticed; they were lining up to participate in the good times, clamoring for loans. FRB policy made this possible, inevitable, and irresistible.<sup>28</sup>

### 3. *Fannie and Freddie*

From this point in the analysis, in contrast to the role of monetary policy as noted above, the impact of the various other related factors becomes somewhat more difficult to assess with any precision. But clearly, to some extent, the federal government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac, facilitated an expansion of mortgage credit that contributed to the credit and housing boom of 1993–2006.<sup>29</sup> Indeed, this was explicitly their purpose and continues

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Blackstone, *Economists Warn of Asset-Price Bubbles*, WALL ST. J., Dec. 14, 2009, at A2.

26. Kind of like today's stock market. See Blackstone, *supra* note 25; see also *infra* note 106. Regarding mortgage fraud, see Michael Corkery, *Fraud Seen as a Driver In Wave of Foreclosures*, WALL ST. J., Dec. 21, 2007, at A1; *infra* Part I.B.6.

27. See *supra* notes 23–25.

28. See *supra* notes 23–25; see also John B. Taylor, *How Government Created the Financial Crisis*, WALL ST. J., Feb. 9, 2009, at A19 (“Monetary excesses were the main cause of the boom.”); Review & Outlook, *Geithner's Revelation*, WALL ST. J., May 12, 2009, at A16. The FRB is now facing some related criticism. See, e.g., Sudeep Reddy & Damian Paletta, *House Attacks Fed, Treasury*, WALL ST. J., Nov. 20, 2009, at A1; Ron Paul & Jim DeMint, *Americans Deserve a Transparent Fed*, WALL ST. J., Nov. 19, 2009, at A21. Of course, it must be conceded that not everyone agrees with the criticism of the FRB. See Alan Greenspan, *The Fed Didn't Cause the Housing Bubble*, WALL ST. J., Mar. 11, 2009, at A15; David Henderson, *Did the Fed Cause the Housing Bubble?*, WALL ST. J., Mar. 27, 2009, at A13. See also Jon Hilsenrath, *Bernanke Challenged on Rates' Role in Bust*, WALL ST. J., Jan. 13, 2010, at A2; David Wessel, *Bernanke's Puzzling Bubble Logic*, WALL ST. J., Jan. 14, 2010, at A2.

29. Indeed, as noted above, essentially the same policies are being pursued today, for the apparent purpose of recreating an asset boom. See *supra* notes 12, 23–25; Louise Story, *Wall St. Finds Profits by Reducing Mortgages*, N.Y. TIMES, Nov. 22, 2009, at 1.

to be today.<sup>30</sup> The GSEs also facilitated the boom in mortgage securitizations<sup>31</sup> and an expansion of the secondary market for subprime mortgage loans,<sup>32</sup> supporting an increase in subprime mortgage lending in 2005–2006 at precisely the worst point in the market cycle. The GSEs increased the impact of the accommodative FRB monetary policy by using their implicit (now explicit) federal guarantees to attract huge sums of world-wide capital to the American mortgage markets, thereby: offering an attractive investment vehicle for investors eager to beat the nominal yields offered by the U.S. Treasury, the FRB, and banks; helping reduce mortgage interest rates to levels that were irresistible to consumers; and generating excess housing demand and over-investment in housing finance.

This had the dual effects of driving up housing prices (contributing to the housing bubble) and driving down mortgage rates, which, in conjunction with rising housing prices, encouraged excess credit by making it seem foolish *not* to borrow money on a house. Of course, when the government subsidizes something, consumers get more of it. The GSEs constitute an enormous taxpayer-backed subsidy for mortgage loans and housing, and, as noted, they expanded this subsidy dramatically at the worst possible time.<sup>33</sup> This encouraged some investors and home buyers to make poor decisions, with

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30. See sources cited *infra* notes 34–36; Editorial, *\$126.9 Billion and Counting*, WALL ST. J., Mar. 1, 2010, at A24.

31. See discussion *infra* Part I.B.5.

32. See, e.g., Eggert, *supra* note 3.

33. See Holman W. Jenkins, Jr., *Reliving the S & L Meltdown*, WALL ST. J., Aug. 20, 2008, at A17 (“In effect, we are reliving the S & L crisis, with two giant S & Ls gambling on survival with taxpayer funds while politicians summon the will to act.”); Judy Shelton, *Loose Money and the Derivative Bubble*, WALL ST. J., Mar. 27, 2009 (“[The GSEs] provided the ‘underlying security’ for many of the derivative contracts [thereby compounding] the error of government intervention . . . . Politicians altered normal credit risk parameters, while the [FRB] distorted housing prices through perpetual inflation.”). In this sense, the GSEs were themselves victims of the market psychology created by FRB monetary policy and their own federal housing and mortgage programs. Interestingly, however, federal authorities have essentially “doubled-down” on this strategy. See, e.g., Editorial, *\$129 Billion and Counting*, *supra* note 30; Editorial, *The Biggest Losers*, WALL ST. J., Jan. 4, 2010, at A16 (noting the continued increase in GSE losses); Nick Timiraos & James R. Hagerty, *Still Broken: No Exit in Sight for U.S. As Fannie, Freddie Flail*, WALL ST. J., Feb. 9, 2010, at A1. It does not appear that the losses have adversely affected executive compensation at the GSEs. See, e.g., Jim Puzzanghera, *Millions for Loan Chiefs Despite Losses*, L.A. TIMES, Dec. 25, 2009, at B1 (noting that Fannie and Freddie CEOs each earn \$6 million annual salaries and supplemental payments).

adverse consequences for themselves, their communities, and U.S. taxpayers.

Today, it is almost amusing to recall how the Bush administration and other public figures promised in early 2008 that the GSEs were well-capitalized and would save the mortgage markets, when the problems that had begun to simmer in 2006–2007 finally came to the attention of the popular media and the public. First, the public was told that the GSEs were the rock-solid saviors of mortgage finance.<sup>34</sup> And, of course, this benefit was supposed to be free (in other words, self-supporting, like similar federal programs including Social Security, Medicare, and deposit insurance).<sup>35</sup> Then, surprisingly, it was announced that a potential bailout might be needed, but with assurances that not more than \$25 billion could ever possibly be needed and that the most likely scenario was for no bailout at all. Then, before we knew it, \$100 billion might be needed, then \$200 billion. Next, the explicit subsidy was \$400 billion,<sup>36</sup> and the ceiling on the subsidy was quietly removed all together, leaving taxpayers with an unlimited liability. Perhaps only the naive are comfortable that we will ever see any of that money again, or that the bailout is complete.<sup>37</sup>

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34. See, e.g., Vikas Bajaj, *Freddie Mac Tightens Standards*, N.Y. TIMES, Feb. 28, 2007, at C1; James R. Hagerty, *Fannie, Freddie Feel Default Heat*, WALL ST. J., Nov. 19, 2007, at A14; Press Release, U.S. Dep't of the Treasury, Paulson Announces GSE Initiatives (July 13, 2008), available at <http://www.treas.gov/press/releases/hp1079.htm>.

35. See, e.g., Edmund L. Andrews & Stephen Labaton, *Mortgage Giants Agreeable to Rescue Plan, but Cost Is Unknown*, N.Y. TIMES, Sept. 7, 2008, at A27; see also Holman W. Jenkins, Jr., Op-Ed., *Rethinking the Fan and Fred Takeover*, WALL ST. J., Mar. 4, 2009, at A13 ("Six weeks before they were seized, their federal regulator . . . declared them more than adequately capitalized."). And then major auto companies, banks, securities firms, etc., received similar treatment. See Bloomberg News, *Treasury Expands Possibilities for Auto Aid*, N.Y. TIMES, Jan. 1, 2009, at B4; Jonathan G.S. Koppell, *Uncle Sam, Subprime Borrower*, WALL ST. J., July 26, 2008, at A9. As noted, when this failed to stimulate the economy, the solution was to increase the bet. See, e.g., Review & Outlook, *Barney Frank's Double Indemnity*, WALL ST. J., April 17, 2009, at A12 (describing efforts to create federal guarantees for municipal bonds); Review & Outlook, *A Republican Fannie Mae*, WALL ST. J., Feb. 6, 2009, at A12 (efforts to create new federal housing subsidies); see also Jonathon GS Koppel, *The Cloning of Fannie and Freddie*, WALL ST. J., Dec. 28, 2009, at A17; Review & Outlook, *Fannie's Next Big Adventure*, WALL ST. J., Oct. 10, 2009, at A14; *supra* note 33; *infra* notes 36–37.

36. See *supra* note 33; *infra* note 37; see also Review & Outlook, *The Fannie Mae Dice Roll Continues*, WALL ST. J., Nov. 11, 2009, at A20.

37. See *supra* note 33; Nick Timiraos & James R. Hagerty, *Big Decision Looms on Fannie, Freddie*, WALL ST. J., Dec. 16, 2009, at A6 (Fannie may need yet another \$100 billion in 2010). Other government-sponsored housing finance programs have fared no better. See Associated Press, *Housing*

So, the GSEs gave us a triple whammy of excessive housing demand and inflated prices, risky over-investment in mortgages and housing at the peak of the bubble, and ongoing massive government subsidies and bailouts that will have to be paid by unrelated members of the public (through slower economic growth, higher taxes, and/or inflation).<sup>38</sup> No one knows exactly how much this will ultimately cost (perhaps it is better not to know) or how it will be paid (ditto). Nor is it possible to know at this point precisely how much this contributed to the credit and housing boom of 1993–2006 or the Great Credit Contraction that followed. Like contract law generally, the GSEs facilitated what people wanted to do, although much more affirmatively and with taxpayer money; presumably, few consumers were unfairly induced into borrowing and spending too much money on a house. Unlike contract law, however, the GSEs drew on a taxpayer subsidy and did more than merely create a legal environment that allowed consumers the freedom to act. The GSEs used public subsidies to actively support and encourage a misallocation of resources into housing, at the peak of a credit bubble, thereby directly encouraging unwise behavior. While the precise impact may never be known, this deserves inclusion on any list of the causes and effects.

Of course, as noted, the GSEs were created precisely for the purpose of encouraging mortgage finance and home ownership, and indeed they continue those efforts today.<sup>39</sup> In view of the retrenchment of private credit and investment that characterizes the Great Credit Contraction, the GSEs, along with the FRB and other

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*Agency's Financial Cushion Deflates*, OKLAHOMAN, Nov. 13, 2009, at 3B; Associated Press, *Government Unveils Plans to Aid State, Local Housing Agencies*, OKLAHOMAN, Oct. 20, 2009, at 3B; Robert C. Pozen, Op-Ed., *Homebuyer Tax Credits Threaten the FHA*, WALL ST. J., Nov. 24, 2009, at A21; Review & Outlook, *Subprime Uncle Sam*, WALL ST. J., Sept. 29, 2009, at A24; Review & Outlook, *The Next Fannie Mae*, WALL ST. J., Aug. 11, 2009, at A16; Review & Outlook, *The Next Housing Bust*, WALL ST. J., May 4, 2009, at A16; Nick Timiraos, *Delinquency Rate Rises on FHA-Backed Loans*, WALL ST. J., April 11, 2009, at A3; Nick Timiraos, *FHA Digging Out After Loans Sour*, WALL ST. J., Nov. 4, 2009, at A2; Nick Timiraos, *Study Sees FHA Taking More Risk*, WALL ST. J., Mar. 5, 2010, at A3 ("The federal government's mortgage-insurance agency is understating how much risk it has taken on . . ."); Can anyone detect a pattern here?

38. See Jeb Hensarling & Paul Ryan, *Why No One Expects a Strong Recovery*, WALL ST. J., Nov. 20, 2009, at A27.

39. See *supra* notes 33–37.

federal agencies and programs, are now the primary sources of mortgage lending.<sup>40</sup> Their role (and that of the public subsidy) has been expanded dramatically in response to the crisis they helped create.<sup>41</sup> Indeed, rather than seeking to prevent another credit bubble, government policy is ardently devoted to creating yet another one, using the GSEs, FRB monetary policy, and a variety of other federal subsidies, bailouts, and stimulus programs.<sup>42</sup> As a result, as General Douglas MacArthur famously said about war,<sup>43</sup> it is unlikely that we have seen the end of misdirected housing and credit subsidies and bailouts, related boom and bust cycles, or the resulting ill-advised housing speculation.

#### 4. *The CRA, ECOA, Fair Housing Act, and Federal Enforcement*

Again, among the many contributing factors, it is difficult to know precisely how much the federal fair credit and housing initiatives contributed to the excessive borrowing and over-investment in housing during the housing and credit boom of 1993–2006. But again, there can be little doubt that they played a role.<sup>44</sup>

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40. See *supra* notes 33–37; Associated Press, *Mortgage Investors Struggle to Survive in Financial Climate*, OKLAHOMAN, Feb. 7, 2010, at 6C.

41. As has the role of the large financial institutions at the heart of the securitization boom. See, e.g., Story, *supra* note 29; *Fannie's Next Big Adventure*, *supra* note 35; Review & Outlook, *Fannie Mae Enron, the Sequel*, WALL ST. J., Aug. 17, 2009, at A10. See generally *supra* notes 33–37; *infra* notes 118, 130.

42. See *supra* notes 25, 33–37; *infra* notes 118, 130. Interestingly, federal loan modification programs are now providing for stated income loans at a 125% loan-to-value (LTV) ratio; these are the same terms sometimes cited as being predatory and contributing to the current crisis. See, e.g., U.S. Department of the Treasury Guidelines for the Homeowner Affordability and Stability Plan (HASP), available at <http://www.treasury.gov/initiatives/eesa/homeowner-affordability-plan/FactSheet.pdf> (last visited Feb. 27, 2010) (125% LTV ratio); Orstein et al., *supra* note 3; Timiraos, *supra* note 1, at A2. The only real question is whether this can succeed without the private capital that has been frightened away by the responses to the current crisis. See *supra* note 3. So far, the answer is not encouraging. See, e.g., Ruth Simon, *Foreclosure Rescue Still Bogged Down*, WALL ST. J., Dec. 11, 2009, at A9; Ruth Simon, *Mortgage Program Gathers Steam After Slow Start*, WALL ST. J., Nov. 11, 2009, at A6; see also *infra* Part II.

43. "Only the dead have seen the end of war." General Douglas MacArthur (quoting Plato), Sylvanus Thayer Award Acceptance Address at West Point, N.Y. (May 12, 1962), available at <http://www.americanrhetoric.com/speeches/douglasmacarthurthayeraward.html>.

44. See Mary Anastasia O'Grady, *The Weekend Interview with Gary Becker: Now Is No Time to Give Up on Markets*, WALL ST. J., Mar. 21, 2009, at A9 ("On top of that [a reference to the FRB's low interest rate policy and excess world liquidity], there were government policies aimed at 'extending the scope of home ownership in the United States to low-credit, low-income families.' This was done

The Equal Credit Opportunity Act (ECOA)<sup>45</sup> and Fair Housing Act<sup>46</sup> have been around since the 1960s, and the Community Reinvestment Act (CRA) since 1977 (together, “these laws”).<sup>47</sup> But these laws did not become major factors in the credit system until the 1990s. The reasons are instructive.

All of these laws have public purposes that are subject to widespread consensus. No one can defend invidious discrimination on grounds of the protected bases in the ECOA, and your author personally witnessed the “redlining” that occurred (with the blessing and even encouragement of some federal regulators) during the 1960s and 1970s as some financial institutions used deposits from older, inner city areas to fund their expansions into more prosperous suburbs.<sup>48</sup> So there can be no doubt that the public policy intentions behind these laws were good and mostly are the subject of a broad

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through ‘the Community Reinvestment Act in the ‘70s and then Fannie Mae and Freddie Mac later on’ and it put many unqualified borrowers into the mix.”(quoting Gary Becker, winner of the 1992 Prize in Economic Sciences)); see also sources cited *infra* note 142.

45. Pub. L. No. 90-321, 82 Stat. 146 (1968) (codified as amended at 15 U.S.C. §§ 1691-1691f (2006)).

46. Pub. L. No. 90-284, 82 Stat. 73 (1968) (codified as amended at 42 U.S.C. §§ 3601-3631 (2000)).

47. Pub. L. No. 95-128, 91 Stat. 1147 (1977) (codified at 12 U.S.C. § 2901). In 1993, the federal financial regulatory agencies published a proposal to significantly expand the impact of the CRA. Proposed Rule, 58 Fed. Reg. 67,466-01 (Dec. 21, 1993). A revised proposed rule was issued the following year. 59 Fed. Reg. 51,232 (Oct. 7, 1994). The Final Rule was issued in 1995. 60 Fed. Reg. 22,156 (May 4, 1995) (codified at 12 C.F.R. pts. 25, 228, 345, 563e); see also Joseph J. Norton, “Fair Lending” Requirements: *The Intervention of a Governmental Social Agenda into Bank Supervision and Regulation*, 49 CONSUMER FIN. L.Q. REP. 17 (1995); David E. Teitelbaum & John M. Casanova, *Regulatory Reform or Retread? The New Community Reinvestment Act Regulations*, 51 BUS. LAW. 831 (1996). This coincided with the beginning of the 1993-2006 credit and housing boom, and was a response to calls by President Clinton in July, 1993 for an expanded CRA regulatory and enforcement regime. See, e.g., Richard D. Marsico, *The New Community Reinvestment Act Regulations: An Attempt at Implementing Performance-Based Standards*, 49 CONSUMER FIN. L.Q. REP. 47 (1995). These developments also coincided with a dramatic increase in fair lending enforcement actions by federal agencies, including the U.S. Department of Justice. See, e.g., Paul H. Schieber, *Decatur Federal and Its Five (So Far) Progeny: U.S. Department of Justice Fair Lending Settlements*, 49 CONSUMER FIN. L.Q. REP. 68 (1995); David E. Teitelbaum & Clarke D. Camper, *Developments in Fair Lending*, 51 BUS. LAW. 843 (1996); David E. Teitelbaum, *Developments in Fair Lending and Community Reinvestment*, 50 BUS. LAW. 1023 (1995).

48. In fairness it should be noted that this was where the credit demand was greatest, to fund suburban growth perhaps fueled in part by a flight of families from the school busing programs designed to integrate inner city school systems. See JACE WEAVER, *THEN TO THE ROCK LET ME FLY: LUTHER BOHANON AND JUDICIAL ACTIVISM* 71-116 (1993) (describing the history of the tumultuous struggle to integrate the Oklahoma City public school system).

consensus. If only that were enough to assure rational implementation and avoid unintended consequences.

That these laws, and particularly the ECOA and Fair Housing Act, coincided with a broad consensus meant that market forces already were at work correcting the abuses. It is apparent that unwarranted discrimination is economically detrimental to all parties concerned, quite aside from the legal issues and these laws. No rational creditor or merchant can ignore the important consumer markets protected by the ECOA, Fair Housing Act, and CRA. By the 1970s, creditors and merchants already were moving rapidly to improve service in underserved markets, though the more rapid increases in suburban housing markets meant that these markets continued to be net importers of capital, while more mature markets experienced net outflows. Together with practical and statutory limitations on the remedies available under the ECOA, Fair Housing Act and CRA,<sup>49</sup> this meant that these laws had little effect until the 1990s.

This changed when the Clinton administration sought to address the credit contraction of 1988–1992 (our latest experience with such a phenomenon prior to the current problems) by using federal authority to mandate expanded credit availability.<sup>50</sup> This reinforced the natural concern (certain to be magnified in the context of any credit contraction—as will no doubt be illustrated again in 2010) that low-income and minority consumers were suffering from reduced credit availability. The Clinton administration apparently understood the relation and adverse impact of a credit contraction on the entire economy, and moved quickly to reverse the rather heavy-handed emphasis of the prior Bush administration on shutting-down banks and thrifts and pursuing enforcement actions against institution-affiliated parties.<sup>51</sup>

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49. See John L. Ropiequet, *Racial Discrimination Claims in Current Mortgage and Auto Finance Litigation: The Song Remains the Same*, 63 CONSUMER FIN. L.Q. REP. 156 (2009); John L. Ropiequet & Nathan O. Lundby, *Dealer Rate Participation Class Actions Under the ECOA: Have We Reached the End of the Road?*, 62 BUS. LAW. 663 (2007).

50. See sources cited *supra* notes 44–47.

51. The latter emphasis undoubtedly contributed to the credit contraction of 1988–1992 and the ensuing recession. Apparently these Bush-era policies were partly a response to politically-sensational allegations that prominent politicians were associated with the collapse of some high-profile thrifts and



As noted, this reversal of public policies in the early 1990s included highly-publicized concerns about credit availability, as is natural (and probably inevitable) in the aftermath of a credit contraction. These concerns were widely expressed in the media and elsewhere.<sup>52</sup> This correlation of policy concerns made it an easy decision for the Clinton administration to reverse the course of the prior Bush administration and seek expanded credit availability. The result was a series of related policy decisions that set the stage for the credit and housing boom of 1993–2006.

These policy decisions included: (1) a shift in bank regulatory policy, from a focus on safety and soundness to increased emphasis on promoting the CRA, fair lending, and increased credit availability; (2) strengthening of the CRA itself;<sup>53</sup> (3) the enactment of HMDA;<sup>54</sup> (4) aggressive fair lending enforcement by various federal agencies;<sup>55</sup> and (5) an unprecedented wave of bank mergers and consolidations, induced in part by the regulatory crackdown of the Bush years and new intrusions of federal policy into bank management and credit underwriting decisions that began in the Bush years (some of which changed the fundamental nature of bank regulation, to the discomfort of many bankers).<sup>56</sup> The latter created unprecedented opportunities for expansion by large banks, through mergers, acquisitions, and branching; but the CRA meant that advocacy groups could (and

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the related taxpayer bailout of the savings and loan deposit insurance system. KANE, *supra* note 17, at 51–55; Harrell, *supra* note 15, at 206–13 (also noting the emotional tone of some media coverage). In any event, the resulting Bush-era crack-down on the financial system probably triggered the credit crunch and serious recession of the early 1990s, an error the Clinton administration was obviously determined not to repeat. See, e.g., *supra* note 47.

52. See Norton, *supra* note 47. This is in stark contrast to the prior demands for retribution against the financial industry for its loose lending standards. See sources cited *supra* note 51.

53. See sources cited *supra* note 47.

54. The Home Mortgage Disclosure Act of 1975, Pub. L. No. 94–200, 89 Stat. 1125 (codified at 12 U.S.C. §§ 2801–10 (2000)); see John L. Ropiequet, Nathan O. Lundby, Kenneth J. Rojc & Sara B. Lubezny, *Update on ECOA and Fair Lending Developments*, 63 BUS. LAW. 663, 666–70 (2008); Joseph T. Lynyak, III, *Developments in Fair Lending Affecting the Residential Mortgage Industry*, 61 CONSUMER FIN. L.Q. REP. 775 (2007); Joseph M. Kolar & Jonathon D. Jerison, *The Home Mortgage Disclosure Act: Its History, Evolution and Limitations*, 59 CONSUMER FIN. L.Q. REP. 189 (2005); Jacqueline S. Akins, *Impact of the Regulation C Revisions*, 56 CONSUMER FIN. L.Q. REP. 289 (2002).

55. See sources cited *supra* note 47.

56. See, e.g., Norton, *supra* note 47; Alvin C. Harrell, *It's the Banking Legislation, Stupid!*, 47 CONSUMER FIN. L.Q. REP. 81 (1993); Alvin C. Harrell, *Commentary, The Wrath of Khan[gress]*, 45 CONSUMER FIN. L.Q. REP. 2 (1991).

would) seek to block these expansions unless the bank demonstrated aggressively that credit was being made available to underserved groups and communities. As a result, many banks devoted significant new resources to lending that did not meet traditional credit underwriting standards. The higher default rates that are inherent in such lending were considered a cost of doing business, required by law as the price for bank expansion.<sup>57</sup>

There were numerous secondary effects—and more than a few ironies—in all of this. The draconian federal agency enforcement powers created in 1988–1993 to assure the safety and soundness of the banking system, by providing the regulatory agencies increased authority to prevent irresponsible lending, were used in part to essentially demand that bankers make CRA loans and fund community organizations and advocacy groups that, in turn, demanded more of the same.<sup>58</sup> Bankers who disagreed had little choice but to leave the business, and many did. One consequence was an unprecedented consolidation of the banking system, away from the decentralized model of locally-owned and locally-managed community banks and thrifts that previously made America unique and traditionally assured Americans of exceptional access to credit.<sup>59</sup> Competitive pricing and loan underwriting by multiple local, independent mortgage originators was largely replaced by uniform, legally-safer national credit scoring systems that allow no room for the creditor to take a risk based on the borrower's non-quantifiable needs and prospects.<sup>60</sup>

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57. Beginning in 2007, as the federal and state crackdown on subprime mortgage lending intensified and borrowers disappeared, housing prices began to decline and these losses turned out to be much worse than many anticipated. See Constance Mitchell Ford, *Foreclosures Continue to Put a Damper on Home Prices*, WALL ST. J., Nov. 11, 2009, at A6; Ruth Simon & James R. Hagerty, *1 in 4 Borrowers Under Water*, WALL ST. J., Nov. 24, 2009, at A1; sources cited *supra* note 3; discussion *infra* at Part I.B.7.

58. See Alvin C. Harrell, *Deposit Insurance Issues and the Implications for the Structure of the American Financial System*, 18 OKLA. CITY U. L. REV. 179 (1993) (describing FIRREA, FDICIA, and the Crime Control Act); see also *supra* notes 44, 56; Norton, *supra* note 47.

59. See sources cited *supra* notes 15, 17. In effect, much of the traditional American financial system was dismantled, beginning in 1989. *Id.*; Harrell, *supra* note 58.

60. See Lynyak, *supra* note 54; sources cited *supra* notes 58, 59.

By the early 1990s these laws and policies had led to a restructured banking system, that, after the essential demise of the traditional thrift industry that had served the nation's housing finance needs for over a century,<sup>61</sup> left large markets of credit-worthy consumers without access to mortgage credit. While financial institutions and many advocacy organizations were being well funded, many consumers were not.<sup>62</sup> As today, this had the makings of a true, long-term credit crisis—with the possibility that governments would be called in to assume direct control of the housing finance system as a final resort. But what happened next surprised nearly everyone. The technology revolution of the 1990s produced personal computer software programs that allowed nearly anyone (with minimal instruction) to master the complex art of originating mortgage loans. Now, almost anyone could be a mortgage broker or a mortgage banker, generating or even originating mortgage loans and earning the fees that such a complex process justifies. An expanding need for subprime mortgage credit met up with an expanding capability for delivering it. All that was needed was a source of funds. And for that problem, centuries-old contract law principles, together with the FRB and GSEs,<sup>63</sup> provided a solution. As so often in the past, contract law provided the legal basis for a series of voluntary relationships that directed private capital to facilitate the satisfaction of social and economic needs. The process was called securitization.

### 5. Securitization

As previously noted, securitization played a role in the credit and housing boom of 1993–2006 and the Great Credit Contraction that followed.<sup>64</sup> Others have examined it at greater length<sup>65</sup> so it need be

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61. See JOSEPHINE HEDGES EWALT, *A BUSINESS REBORN, THE SAVINGS AND LOAN STORY, 1930–1960* chs. 1, 9, 10, app. 2 (1962); sources cited *supra* notes 58, 59.

62. See Alvin C. Harrell, *Strong Banks, Weak Economy*, 46 CONSUMER FIN. L.Q. REP. 49 (1992); see also *infra* note 109 (noting similar conditions today); sources cited *supra* notes 1, 3 (same).

63. See *supra* Parts I.B.2–3.

64. See, e.g., Alvin C. Harrell, *The Subprime Lending Crisis—the Perfect Credit Storm?*, 61 CONSUMER FIN. L.Q. REP. 626 (2007).

65. See, e.g., Eggert, *supra* note 3 (citing numerous other sources); Derrick M. Land, *Residential Mortgage Securitization and Consumer Welfare*, 61 CONSUMER FIN. L.Q. REP. 208 (2007).

noted only briefly here. But, even in this brief treatment, it is apparent that, once again, ironies abound.

As suggested immediately above at Part I.B.4, in the latter part of the Twentieth Century and especially following the impairment of the traditional thrift industry in the late 1980s and early 1990s, concerns were expressed, in the media and by policy makers and consumer advocates, as to whether consumers would have sufficient access to mortgage credit.<sup>66</sup> The policy responses included federal initiatives such as the ECOA, CRA, HMDA, and increased fair lending enforcement efforts,<sup>67</sup> all designed to mandate increased availability of credit for minority, low-income, inner city, and other protected classes of subprime borrowers.<sup>68</sup> These concerns were elevated to even greater prominence in the early 1990s, with respect to mortgage credit, following the contraction of the traditional thrift industry, as thrifts were historically the primary financial intermediaries willing to originate large volumes of long-term fixed-rate residential mortgage loans and hold them in the institution's "portfolio."<sup>69</sup>

As the thrift industry retrenched in response to onerous new laws and regulations, and the community banking system also (for many of the same reasons) entered a significant consolidation phase,<sup>70</sup> credit tightened and by the early 1990s a "credit crunch" ensued. The need for increased credit availability became a paramount national priority, and as noted above the traditional tools of federal law, including mandates, enforcement, actions and penalties, subsidies (including deposit insurance and implicit federal guarantees for Fannie and Freddie), tax benefits, monetary policy and direct funding, were brought to bear in an increasingly aggressive manner.<sup>71</sup>

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66. See *supra* notes 44–47 and accompanying text.

67. See *supra* Part I.B.4.

68. See *supra* Part I.B.4; Gottlieb & McGuinness, *supra* note 3 (noting that some municipalities suing lenders for extending inner-city mortgage credit previously pressured lenders to do exactly that).

69. See EWALT, *supra* note 61. Thus the moniker "portfolio lending" describes this practice. This reliance on investments in long-term, fixed-rate mortgage loans, required by federal law and regulation, was a prescription for disaster when interest rates skyrocketed in the 1970s and 1980s. This story has been told elsewhere. Harrell, *supra* note 17; Harrell, *supra* note 15.

70. See Harrell, *supra* note 17; Harrell, *supra* note 15; see also sources cited *supra* notes 17, 51–52, 56–58.

71. See *supra* notes 17, 51–52, 56–58; see also *supra* Part I.B.4. This may sound familiar to those

But here is another irony: these 1990s federal initiatives undoubtedly had an effect, though perhaps in unexpected ways and some more than others.<sup>72</sup> Yet the dramatic increase in the availability of credit for subprime borrowers in 1993–2006 would not have been possible without private sector innovations based on the most traditional of our state common law principles: the law of contracts, which made possible the world-wide securitization of mortgage loans.

Here is the irony: securitization made possible the “democratization of credit,” that is, the widespread availability of relatively low-cost private mortgage credit, a historically desirable and unprecedented development.<sup>73</sup> This was precisely the goal of the assorted federal laws and policies noted above, but was achieved largely without the help of any of them, instead relying primarily on private capital from unregulated sources (with the prominent exceptions of FRB monetary policy and, to some extent, Fannie and Freddie).<sup>74</sup> Again, ironically, some of those who had demanded the

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observing today’s headlines. Once again today the nation is experiencing a credit contraction induced by onerous laws and excessive regulation. *See, e.g., supra* notes 2, 3, 5, 7; Holman W. Jenkins, Jr., *Washington’s Suicide Mission*, WALL ST. J., Oct. 28, 2009, at A21 (“The urgent problem is the giant riverboat gamble that Washington can save the economy by doing what comes naturally—spending money carelessly, creating massive new entitlements without funding them, dishing out cheap credit to politically favored sectors, [and] telling business people where and how to invest.”). But this time the results are likely to be very different than in the 1990s, as discussed below and at Part II; *see also* Peter Eavis, *Finance Fixers Still Living in Denial*, WALL ST. J., Dec. 16, 2009, at C18; Peter Eavis, *Congress’s Moral Hazard*, WALL ST. J., Nov. 19, 2009, at C14 (noting the counter-productive nature of many current legislative proposals).

72. Monetary policy, for example, has already been mentioned as a major factor, *see supra* Part I.B.2., as have Fannie and Freddie, *see* Part I.B.3. and CRA, etc., Part I.B.4.

73. *See* S. Mitra Kalita, *The ‘Democratization of Credit’ Is Over—Now It’s Payback Time*, WALL ST. J., Oct. 10–11, 2009, at A1.

74. *See supra* Parts I.B.2–4. If you doubt this statement in the text, consider that these same federal policies are being replicated today, in some cases (including monetary policy and funding by Fannie and Freddie) on a significantly grander scale, the primary difference being a lack of any material role for private risk capital. *See* Heard on the Street, *U.S.’s Grossly Distorted Product*, WALL ST. J., Oct. 30, 2009, at C10 (“Washington provides tax breaks to first-time buyers, guarantees most of the mortgages written, and then buys most of those . . .”). Consequently, this time the results are quite different: much of the mortgage market, dependent almost entirely on federal initiatives, is starved for credit; housing prices continue at depressed levels unemployment remains stubbornly high; and foreclosures are skyrocketing. *See* sources cited *supra* notes 2, 3; *supra* notes 71–73. *See also* Robert B. Reich, *The Economy: A Year Full of Challenges*; *Main Street, Suckered Again*, L.A. TIMES, Dec. 27, 2009, at A39; David Streitfield, *A Battered City Fears the End of Housing Aid*, N.Y. TIMES, Feb. 15, 2010, at A1; Mark Whitehouse, *Turbulent Markets: Rising U.S. Job Worries Add to Upheaval*, WALL ST. J., Feb. 5,

democratization of credit, through federal or local policies mandating increased credit availability for marginal borrowers, soon began attacking securitization because it accomplished these very purposes, allegedly enabling consumers to borrow and spend too much money.<sup>75</sup>

There can be no doubt that securitization played a major role in facilitating the credit and housing boom of 1993–2006. It provided a substitute for the portfolio lending of a declining thrift industry, and a legal structure for transactions allowing all of those involved—borrowers, brokers, mortgage bankers, securities firms, and investors—to do what they wanted to do: invest in the real estate boom. In turn, this reinforced the boom (as easy credit always does). One can hardly blame these private market participants for wanting to join in the housing boom and resulting economic prosperity, and it is unfair to do so (absent fraud, as discussed below). If there is blame for not preventing the bubble, it lies primarily with the monetary policy and other government programs that first created the boom and then undercut it, not those merely seeking to ride the wave, though it is probably asking too much to expect any federal authority to manage or constrain rising housing prices in a timely and appropriate manner (especially in our politically-charged economic environment). Securitization undoubtedly facilitated the funding of mortgage loans by spreading (and therefore seeming to understate) the risks, as it was supposed to do; ironically, then, securitization is blamed for doing exactly what it was designed to do: facilitate expanded credit availability, and reduce its cost, by attracting private capital and spreading the financial risk. But it is inappropriate to blame this for housing and credit cycles.

Yet, this is pretty much what the critics of securitization are saying: “securitization encouraged market participants to push risk to

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2010, at A9. The primary variable that has changed is the loss of private credit, for example, through securitizations, for the reasons noted below. This provides an unusually clear-cut control factor in our continuing experimentation with a reliance on federal housing and credit policy. See *Mortgage Investors Struggle to Survive in Financial Climate*, *supra* note 40; sources cited *supra* note 42.

75. See, e.g., Kalita, *supra* note 73; Eggert, *supra* note 3; Gottlieb & McGuinness, *supra* note 3. Again, this is akin to blaming the messenger; obviously, if credit is more widely available, more people will use it, and there will be more defaults, especially in a subsequent recession.

the very edge of what the applicable market standards would tolerate . . . . Thinly capitalized subprime lenders could generate large numbers of loans likely to default . . . .”<sup>76</sup> In effect, securitization allowed private parties to enter mortgage contracts, so they did so with wild abandon, thereby causing a boom and bust cycle. Of course, there is some truth to this: securitization allowed subprime consumers, brokers, mortgage bankers, securities firms, and investors to do precisely what they wanted to do—and what seemed attractive and beneficial in a period of rising housing prices and home-ownership rates. Those who joined in this enterprise early enough did quite well (at least for awhile), and if the boom had not ended, many of those who now suffer would be congratulating themselves for their financial acumen. Their actual experience is one often shared by others who have chased a credit boom by investing in commodities, the stock market, bonds, or almost any other type of asset or investment transaction at the peak of a credit cycle. In this respect consumers are in good company, having shared the adverse effects of the Great Credit Contraction with a star-studded cast of professional investors and brilliant financial minds.<sup>77</sup>

There are public policy risks to an over-emphasis on these issues. The only way to prevent people from making such mistakes is to prevent them from being able to borrow money to participate in economic booms. One way to do this is to significantly restrict private credit and contract law because these are the mechanisms by which people participate in such transactions, perhaps substituting public funding mechanisms designed to target credit availability to selected groups and institutions and limit it to socially desirable purposes. As noted below, our public policy has now moved decisively in that direction and, as a result, in conjunction with the end of the credit and housing boom of 1993–2006 and the Great

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76. Eggert, *supra* note 3, at 1257, 1276–81. *Cf.* authorities cited *supra* note 28.

77. See sources cited *supra* note 6 (noting the history of such things and the role of “collective hallucination,” which (it should be noted) is not limited to consumers and also afflicts voters, scientists, and public offices). See also sources cited *supra* note 23, regarding the financial perils of resisting or being left out of such a boom; O’Grady, *supra* note 44 (noting the rationality of efforts to participate in an inflationary economic boom); sources cited *supra* note 28.

Credit Contraction, private subprime mortgage lending and securitization has come almost to a halt.<sup>78</sup> Federal agencies direct and essentially fund the mortgage credit that is now flowing, assuming that it is targeted at select recipients.<sup>79</sup> So the opponents of private securitizations now have it their way; this kind of lending has nearly ceased, and the consumer mortgage markets are again (as in the early 1990s) largely dependent on direct federal mandates, enforcement, and funding.<sup>80</sup>

### 6. Mortgage Fraud

No discussion of the credit and housing boom of 1993–2006 and the Great Credit Contraction that has followed would be complete without a discussion of mortgage fraud. Again there is a sense of déjà vu in this; those of us who followed this area of law during the previous credit and housing boom and collapse, characterized by the deposit insurance crises of the late 1980s and early 1990s, may recall the public focus throughout that period on fraud and abuse by “S & L Kingpins” and other financial insiders.<sup>81</sup> One could hardly turn on the

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78. See, e.g., Elizabeth Williamson, *Obama Slams 'Fat Cat' Bankers*, WALL ST. J., Dec. 14, 2009, at A4; Fields, *supra* note 3; Heard on the Street, *supra* note 74; sources cited *supra* notes 33–38. Of course, it is not clear that the new regulation and subsidies will, in fact, result in an optimal allocation of resources. See Associated Press, *Nobel Winners Study Keys to Financial Crisis*, OKLAHOMAN, Oct. 13, 2009, at 5B (“the scholars’ research did not suggest that more government oversight would prevent financial crises.”); Review & Outlook, *Hope vs. Financial Experience*, WALL ST. J., June 18, 2009, at A16; see also Damian Paletta & David Enrich, *Loopholes Lurk in Bank Bill*, WALL ST. J., Dec. 11, 2009, at C1 (noting special interest provisions in the 2009 financial “reform” bill); Louise Story, *Investment Funds Profit Again, This Time by Paring Mortgages*, N.Y. TIMES, Nov. 22, 2009, at 1 (noting the large profits being reaped by the investment funds that contributed to the housing bubble); *supra* note 71; sources cited *supra* notes 33–38. Nonetheless, that is clearly the current direction of American policy. See, e.g., Alvin C. Harrell, *The Proposed Consumer Financial Protection Agency Act*, 63 CONSUMER FIN. L.Q. REP. 140 (2009); *infra* Parts II, III. Something that should, perhaps, be of concern to consumers is whether our individual borrowing and consumption preferences will be deemed socially desirable by our government overseers.

79. See sources cited *supra* note 78; see also Associated Press, *Home Tax Credit May Help*, OKLAHOMAN, Nov. 24, 2009, at 1B (“[T]he gains in October [2009] mainly reflected the tax credit of up to \$8,000 for new homeowners . . .”). See also sources cited *supra* notes 33–38; Asher Hawkins, *FHA: The Feds’ Next Housing Debacle*, FORBES, Mar. 15, 2010, at 26 (noting likelihood of fraud).

80. See sources cited, *supra* note 79. The results, however, were predictable: “I wouldn’t want to bet the house on housing . . . in terms of the strength of the U.S. economy . . .” *Home Tax Credit May Help*, *supra* note 79 (quoting Diane Swonk, chief economist at Mesirow Financial in Chicago); see also Ruth Simon, *Foreclosure Rescue Still Bogged Down*, WALL ST. J., Dec. 11, 2009, at A9.

81. See Harrell, *supra* note 15, at 946.



television or open a newspaper without being told of public “outrage” over such abuses.<sup>82</sup> In the end, of course, it was structural factors (including, as again in the past fifteen years, federal laws and regulatory policy<sup>83</sup>) that caused most of the problems, and insider abuse was a very minor factor in the losses.<sup>84</sup>

And so it goes again. Today, mortgage fraud is sometimes said to have been a major cause of the credit and housing boom of 1993–2006, and the Great Credit Contraction that followed.<sup>85</sup> Typically this is said to be the result of inadequate regulation, thus supporting the agenda of those who see more regulation as the answer to all such problems.<sup>86</sup> A typical quote comes from the Attorney General of Illinois, courtesy of Professor Eggert: “It was no easy matter to prove that questionable products and practices were illegal when there were no written federal rules or regulations specifically prohibiting them.”<sup>87</sup> But preventing fraud and deception, in all aspects of human endeavors, always has proved to be easier said than done, even when the practices are specifically prohibited. This line of analysis may lead to the conclusion that the only effective solution is to prohibit essentially everything, unless it is expressly approved by the government, because otherwise someone will come up with a new variation (such as securitization in the 1990s) that overcomes the existing limitations.<sup>88</sup> It is not hard to see where this will lead.

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82. *Id.*

83. *See supra* Parts I.B.2–4.

84. Somehow, however, the popular media missed that part of the story. Lurid tales of insider abuse are just so much more marketable than analyses of federal housing law and credit policy. *See* sources cited *supra* notes 15, 17.

85. *See* Eggert, *supra* note 3, at 1284–89. This “fact” is often simply taken for granted. *See, e.g., infra* note 86.

86. Recently your author attended a panel discussion that included federal regulatory agency representatives. The subject was the housing and credit crisis and potential solutions. Not surprisingly, the consensus was that more regulation was the answer. Some members of the audience openly treated this as an established fact, while others treated it as a revelation. In reality, the federalization of mortgage finance probably enhances the prospects for mortgage fraud. *See, e.g., Hawkins, supra* note 79.

87. *See* Eggert, *supra* note 3, at 1284 (quoting *Federal and State Enforcement of Financial Consumer and Investor Protection Laws: Hearings Before the H. Comm. on Financial Services*, 111th Cong. 8 (2009) (testimony of Lisa Madigan, Ill. Attorney Gen.)). Yes, it is definitely a challenge to prove that practices are illegal when they are not prohibited.

88. The proposed federal Consumer Financial Protection Agency will facilitate this approach. *See* Harrell, *supra* note 78.

A problem in any discussion of mortgage fraud is that it is one of those chameleon-like terms (like “privacy” or “predatory lending”) that mean different things to different people. Almost everyone is against bad things, so agreement based on vague terminology and broad principles may come easy. But the law requires specifics. Creditors (and some statistics) may refer to the term “mortgage fraud” as meaning deception by the borrower, such as a fraudulent credit application;<sup>89</sup> others may use the term to refer to fraud by the appraiser, or broker, or creditor, or all three (for example, a loan knowingly based on a fraudulent appraisal).<sup>90</sup> Professor Eggert acknowledges this,<sup>91</sup> resisting the temptation to focus entirely on one party or the other.<sup>92</sup> Some cases of mortgage fraud are easy to identify and label. But, for some purposes, the term remains largely undefined.

Mortgage fraud always becomes more apparent at the end of a credit and housing boom. Obviously, booming housing markets and expanding credit availability provide continuous opportunities to refinance, thereby papering over many mistakes and even prior fraud. Fraudulent loan applications and appraisals may be effectively “cured” (or at least rendered irrelevant) by an expanding economy with rising incomes and property values. The same is true of many other types of lending and investment problems. An economic boom obscures many mistakes. But all of this changes when markets decline or even collapse. Suddenly, even the best decisions may look bad, and the worst ones really terrible. At this point, revelations (and accusations) of fraud and abuse become more common.

This has been going on at least for centuries, and probably longer. It is not clear to your author that there is a simple, easy solution. Even the best experts often fail to recognize these problems in advance, and continually increasing the legal sanctions has not helped.<sup>93</sup>

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89. See Therese G. Franzén, *Update on Mortgage Fraud—What Is Happening Today?*, 62 CONSUMER FIN. L.Q. REP. 14 (2008); Loretta Salzano & A. Michelle Canter, *Identifying and Stopping Mortgage Fraud*, 61 CONSUMER FIN. L.Q. REP. 16 (2007).

90. See Eggert, *supra* note 3, at 1287–88.

91. *Id.* at 1284, 1286, 1289–90.

92. *Id.* at 1286–92.

93. For examples, see sources cited *supra* notes 15, 17, 58, 78, and 79. For some practical pointers,

Despite obvious exceptions,<sup>94</sup> it appears that mortgage fraud neither played a major role in the credit and housing boom of 1993–2006 (though that is obviously not the case in some local markets and transactions) nor offers much prospect in terms of a solution to prevent future credit and housing cycles. For one thing, as long as there are government programs offering free money (or tax credits), there is likely to be fraud.<sup>95</sup> But the greater danger is that solutions directed at stamping-out mortgage fraud and other abuses may have unintended adverse consequences that exceed their benefits, as suggested below.

### 7. *Anti-Predatory Lending Laws*

The developments noted above at Parts I.B.2–6 have been widely, if not unanimously, recognized as factors contributing to the credit and housing boom of 1993–2006. The issues discussed below are different, in at least two ways: (1) generally they have not been recognized in the media (perhaps due to the technical, legal nature of the issues); and (2) these are factors that contributed not to the credit and housing boom of 1993–2006 but to its collapse. Some additional irony: these are perhaps the most important issues, as they help explain not the boom,<sup>96</sup> but why it ended so disastrously in the Great Credit Contraction; yet, these factors have received the least attention of all.

Your author and others have noted these issues before.<sup>97</sup> The basic point is that the credit and housing boom of 1993–2006 ended, becoming instead the Great Credit Contraction that has followed, in significant measure due to the imposition of new restrictive state and federal laws and regulatory initiatives designed to prevent “predatory” subprime lending. Some of these restrictions on credit

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however, see Franzén, *supra* note 89, and Salzano & Canter, *supra* note 89.

94. See sources cited *supra* note 89.

95. See Pozen, *supra* note 37; Hawkins, *supra* note 79.

96. Explaining the boom is the easy part. See *supra* Parts I.B.2–5.

97. See Donald C. Lampe, Fred H. Miller & Alvin C. Harrell, *Introduction to the 2009 Annual Survey of Consumer Financial Services Law*, 63 BUS. LAW. 561 (2008); Alvin C. Harrell, *Commentary: The Subprime Lending Crisis—The Perfect Credit Storm?*, 61 CONSUMER FIN. L.Q. REP. 626 (2007).

came at the peak of the credit and housing boom of 1993–2006 (indeed, the boom may have peaked at that time in large measure for this reason), while others were imposed as the Great Credit Contraction began (thereby worsening the crash); together these measures helped to push the consumer mortgage credit system—and ultimately the entire economy, which depends on such credit—over the precipice (helped along by a brief and simultaneous period of FRB tightening<sup>98</sup>). At the time, those who tried to point out that these new restrictions on mortgage credit would reduce the availability of mortgage credit were ignored or shouted down.<sup>99</sup> Yet, that was inevitable and precisely what happened.

Of course, economic booms end for many reasons, and probably for reasons that no one fully understands (perhaps owing in part to extraordinary delusions and the madness of crowds<sup>100</sup>). In any event, it seems apparent that they do end; so it always has been and always will be.<sup>101</sup> Like earthquakes, it has yet to be demonstrated that anyone can predict economic booms and busts with any degree of precision, continual pretensions to the contrary notwithstanding. So, no one knows for sure why or when these cycles will begin and end, or likewise why and when the painful aftermath will moderate (though, as noted above and *supra* at Parts I.B.2–6, and discussed further below, public policy can help or hurt).

To some extent, economic booms probably just run out of steam. In the case of the credit and housing boom of 1993–2006, housing demand and prices rose so dramatically and for so long that affordability became an obvious problem. At some point in a boom cycle asset prices so far outpace incomes that few can afford to play the game, no matter how low interest rates are or how much credit is

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98. See sources cited *supra* note 97; see also *supra* notes 5, 28; Associated Press, *Fed Freezes Interest Rates as Economy Caps Inflation*, OKLAHOMAN, Dec. 17, 2009, at 1B (includes a graph illustrating the spike in a key FRB interest rate in roughly the period 2005–2007).

99. At one program your author attended, this suggestion drew the following response from the program speaker: “That’s crap, just crap.” See also Harrell, *supra* note 78.

100. See CHARLES MACKAY, EXTRAORDINARY POPULAR DELUSIONS AND THE MADNESS OF CROWDS (2009). Others have called this a “collective hallucination.” See Gomes, *supra* note 6.

101. Of course, measures which restrict freedom of contract may prevent some from participating in the boom (and bust), thereby moderating the cycle by leaving much of the economy in the trough, but the cycles exist nonetheless. See sources cited *supra* notes 5, 6, 78.

available. And, at some point, absent a willingness to destroy the currency as an effective source of value and medium of exchange, the FRB must tighten its monetary policy and raise interest rates (of course, if it does not, the boom can go on but at the cost of even greater economic problems—and this ever-present possibility is one of the factors that sustain asset booms, and make economic predictions so difficult, and frequently inaccurate).<sup>102</sup> At some point, investor concern about these and related issues (including the potential for a political backlash) may result in a flight of capital; when this becomes a rush to the exits, the bubble collapses. Such events apparently coalesced in the United States in roughly 2007.<sup>103</sup>

This has happened many times before, and historically the markets have adjusted and rebounded rapidly. But this time there are some unusual factors at work, with the downward cycle being reinforced by new restrictions on consumer credit transactions (and threats of even more), which are making the Great Credit Contraction worse. As these restrictions (and the increased risks) became more widely apparent, the end of the credit and housing boom of 1993–2006 was hastened and became more pronounced, and transformed into something unusual in American history: an extended credit crunch referred to here as the Great Credit Contraction. There can be no doubt that a housing (and economic) boom is built on a credit expansion, and that restrictions on credit can reverse that process. That is what happened in the latter part of the first decade of this century, as states and federal agencies turned increasingly hostile to mortgage credit transactions, under the rubric of combating predatory lending.<sup>104</sup> Probably even the FRB was surprised by the dramatic events that followed, including a collapse of the credit cycle and ultimately the economy, as the promises of a “soft landing” came to naught.

At the time of this writing we are well into the third year of the Great Credit Contraction, with no end in sight despite trillions of

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102. See sources cited *supra* notes 6, 23, 25.

103. See Lampe, Miller & Harrell, *supra* note 97.

104. *Id.*; see also sources cited *supra* notes 3, 5–6.

dollars of remedial “stimulus” and bailout spending.<sup>105</sup> While this spending has subsidized a few large entities, and has created some new bubbles and risks,<sup>106</sup> it has not addressed the basic problems afflicting the credit markets.<sup>107</sup> The closest we have come to a public recognition of these basic issues is the public badgering of bankers and regulators by politicians, in an apparent effort to deflect attention from the problems created by ill-advised laws and regulations and other policy initiatives.<sup>108</sup> At some point, if we are to move beyond the current reliance on federal funding and resuscitate normal mortgage lending, state and federal policy makers will need to recognize the adverse impacts of their crackdowns on subprime mortgage lending and create a more rational legal environment for credit transactions.<sup>109</sup> Private investors and creditors cannot be expected to fully return to these markets until they are comfortable that mortgage liens and credit contracts will again be routinely enforceable.<sup>110</sup>

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105. See, e.g. Ron Paul, *On My Mind*, FORBES, Nov. 16, 2009, at 26 (“[T]he [FRB’s] balance sheet remains bloated at an unprecedented \$2 trillion.”); sources cited *supra* notes 2, 3.

106. See Bernard Cordon, *The Amnesia in Financial Markets*, FORBES, Nov. 16, 2009, at 30 (“The biggest Bernanke bubble of all: the stock market, which has surged 56% since its March [2009] low.”); see also sources cited *supra* notes 25–29. This has created a whole new range of financial risks. See sources cited *supra* notes 33–37.

107. See Steve Forbes, *Bair Market*, FORBES, Nov. 16, 2009, at 16 (“[T]he economy won’t be creating jobs unless the credit system is fully functioning again—and we’re still a long way from that.”); Associated Press, *Reports on Economy Signal Slight Rebound*, OKLAHOMAN, Nov. 25, 2009, at 3B; sources cited *supra* note 2.

108. See Damian Paletta, *Bank Crackdown Draws Criticism*, WALL ST. J., Nov. 5, 2009, at C1. “Some former regulators say the efforts resemble efforts made by lawmakers in the early 1990s that prompted bank examiners to relax the rules at the height of the savings-and-loan crisis. That prolonged the life of some weaker banks and let them dig deeper financial holes.” *Id.* at C4; see also Williamson, *supra* note 78; *supra* notes 15, 17.

109. See Forbes, *supra* note 107 (“The Treasury Department’s pressure on lenders to tear up mortgage contracts has killed any private-sector appetite for mortgage-backed securities. The only one buying this stuff these days is the [FRB].”); Gerald P. O’Driscoll, Jr., *Obama vs. the Banks*, WALL ST. J., Dec. 17, 2009, at A27 (“The Fed’s policy makes sense if the goal is restoring bank profitability . . . . It is a terrible policy if the goal is fueling small business, the engine of economic growth and job creation.”); see also sources cited *supra* notes 2, 3, 74.

110. See *supra* notes 2, 3, 74.

## II. CONSEQUENCES AND PROSPECTS

The discussion above at Part I describes the causes of the credit and housing boom of 1993–2006 and Part I.B.7 briefly notes some of the reasons it ended.<sup>111</sup> The discussion below focuses on the Great Credit Contraction that followed, including subsequent measures and proposals seeking to address the consequences, which continue to be widespread despite three years of unprecedented federal stimulus efforts.<sup>112</sup>

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111. See also Lampe, Miller & Harrell, *supra* note 97; Harrell, *supra* note 97. As noted here and predicted in those articles, the credit contraction continues to impair the economy, despite massive new injections of federal money into the credit markets beginning in 2007–2008. See Associated Press, *Spending Drop Hurts Stocks*, OKLAHOMAN, Aug. 18, 2009, at 1B; Associated Press, *Bank Lending May Stay Tight Through 2010, Survey Shows*, OKLAHOMAN, Aug. 18, 2009, at 3B; Edmund L. Andrews, *Vast Bailout by U.S. Proposed in Bid to Stem Financial Crisis*, N.Y. TIMES, Sept. 18, 2008, at A1; Jon Hilsenrath, Serena Ng & Damian Paletta, *Worst Crisis Since '30s, With No End Yet in Sight*, WALL ST. J., Sept. 18, 2008, at A1; Louis Uchitelle, *Tighter Credit Transforming the Economy*, N.Y. TIMES, Sept. 19, 2008, at A1; sources cited *supra* notes 1, 2, 3, 74, 109.

112. See sources cited *supra* notes 1, 2, 3, 107–111; Deborah Solomon, James R. Hagerly & Michael Crittenden, *Strains Mount on Bailout Plans—American Express Gets Quicker Access to U.S. Cash; Fannie Mae May Need More Help*, WALL ST. J., Nov. 11, 2008, at A1; David Streitfeld, *Almost Entire Town Is Drowning in Debt as Home Values Plunge*, N.Y. TIMES, Nov. 11, 2008, at A1, A21; Jon Hilsenrath, David Enrich & Deborah Solomon, *Credit Crisis Strains the Government's Options*, WALL ST. J., Sept. 12, 2008, at A1; Vikas Bajaj, *Housing Lenders Fear Bigger Wave of Loan Defaults*, N.Y. TIMES, Aug. 4, 2008, at A1. If there was ever any doubt, this serves as a reminder of the link between credit availability and economic growth. See Conor Dougherty, Amy Merrick & Anton Troianovski, *States Slammed by Tax Shortfalls*, WALL ST. J., July 24, 2008, at A1; Jesse Drucker, *U.S. News: States' Tax Receipts Fell Sharply in Latest Quarter—Spending Reductions Triggered by Balanced-Budget Rules Threaten to Weaken Demand and Magnify Economic Downturn*, WALL ST. J., Oct. 25, 2008, at A3; Charles Jaffe, *Like It or Not, Everyone Affected by Credit Crunch*, TULSA WORLD, Aug. 27, 2008 (describing some of the ways the credit crunch impacts consumers); Jennifer Levitz, Ilan Brat & Nicholas Casey, *Wall Street's Ills Seep into Everyday Lives*, WALL ST. J., Sept. 19, 2008, at A2; Jeffrey McCracken, Vanessa O'Connell & Ray A. Smith, *Retail Losses Sap a Jobs Safety Net*, WALL ST. J., Nov. 11, 2008, at A1; Prabha Nararajan & Robin Sidel, *Bond Woes Choke Off Some Credit to Consumers*, WALL ST. J., Nov. 6, 2008, at C1; Aparajita Saha-Bubna & Prabha Natarajan, *Credit-Card Bonds Fight a Tougher Debt Market*, WALL ST. J., Aug. 5, 2008; John T. Stoll, *Tight Credit Puts Squeeze on Big Three Auto Dealers*, WALL ST. J., Aug. 28, 2008, at B1; Peter Thal Larsen, *StanChart Warns Growth Set to Slow*, FIN. TIMES, Aug. 5, 2008, at 1; sources cited *supra* note 5; sources cited immediately above. As noted *supra* at Part I.B.7 and discussed further below, structural legal factors contributing to these conditions apparently have blunted the effectiveness of FRB monetary policy, with the result that the aggressive FRB monetary responses since 2007 have created a potential commodities bubble and potential inflationary pressures without preventing a credit contraction or recession. See Mark Gongloff, *Ahead of the Tape*, WALL ST. J., Aug. 4, 2008, at C1; Kelly Evans, *U.S. News: Price Increases Ramp Up, Sounding Inflation Alarm—Stimulus Checks Fuel Consumer Spending; Incomes Fall Behind*, WALL ST. J., Aug. 5, 2008, at A3; Don Mecoy, *Why Inflation May Be Biggest Threat*, OKLAHOMAN, May 14, 2008, at 1B; Ben Steil, *We'll All Pay for the Fed's Loose Money Follies*, WALL ST. J., Aug. 18, 2008, at A13; Brian Wesbury, *Inflation is a Clear and Present Danger*, WALL ST. J.,

First, some general observations about the nature of the policy responses to the Great Credit Contraction. These responses reflect a distinct bias in favor of federal administration and funding, at the expense of private mortgage finance (for example, simultaneously discouraging private finance and increasing federal subsidies for consumer credit transactions).<sup>113</sup> Thus, the current displacement of private funding by federal funding appears to be a conscious policy choice rather than merely a response to the recent crisis. This also reflects, perhaps to an unusual degree, the polarization of political thought in America today, representing a significantly different approach to addressing the mortgage needs of consumers, as compared to traditional funding mechanisms. Beyond this, policy makers and the media have seemingly failed to recognize the fundamental nature of the problems afflicting the credit markets.<sup>114</sup> The result is a focus on federal bailouts and subsidies, while other policies continue to restrain essential, routine consumer

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Aug. 19, 2008, at A17; *No Quick Fix*, OKLAHOMAN, Sept. 18, 2008, at 5B (“Despite the government’s repeated attempts to calm financial markets, credit just keeps getting tighter.”); *see also* sources cited *supra* notes 23, 25, 28–29, 74.

113. *See* Bryan Caplan, *Special Interest Secret*, WALL ST. J., May 12, 2007, at A11; *see also* Lampe, Miller & Harrell, *supra* note 97, at 563 & nn.10–13; Harrell, *supra* note 97; Damian Paletta & David Enrich, *Loopholes Lurk in Bank Bill—USAA, GE and Others Gain Exceptions to Full Impact of Regulatory Overhaul*, WALL ST. J., Dec. 11, 2009, at C1; *see also* sources cited *supra* notes 3, 8, 71, 74; *infra* Parts II, III.

114. Including the causes and effects. *See* sources cited *supra* notes 1–3, *supra* Part II. *See also* Peter Eavis, *Finance Fixers Still Living in Denial*, WALL ST. J., Dec. 16, 2009, at C18; Peter Eavis, *Congress’s Moral Hazard*, WALL ST. J., Nov. 19, 2009, at C14; Review & Outlook, *Banker Baiting 101*, WALL ST. J., Dec. 15, 2009, at A20; Brian M. Carney, *The Weekend Interview with Anna Schwartz: Bernanke is Fighting the Last War*, WALL ST. J., Oct. 18, 2008, at A11; James Grant, Essay, *The Confidence Game*, WALL ST. J., Oct. 18, 2008, at W1; Holman W. Jenkins, Jr., *Obama’s Dangerous Bank Bailout*, WALL ST. J., Feb. 4, 2009, at A11 (restoring Citi and Bank of America to greatness shouldn’t be the goal); sources cited *supra* notes 71, 74, 109; *see also* Review & Outlook, *Calling Hank Paulson*, WALL ST. J., Aug. 28, 2008, at A14 (asserting that the responses to date were an example of how not to reassure bank depositors and credit markets); Ethen Penner, *How Low Interest Rates Contributed to the Credit Crisis*, WALL ST. J., Aug. 18, 2008, at A15; Krishna Guha, *Greenspan Warns of More Bank Bailouts*, FIN. TIMES, Aug. 5, 2008, at 1 (“Mr. Greenspan cautions that a heavy handed regulatory response to the crisis would do more harm than good . . . .”); Lawrence B. Lindsey, *Hank Paulson’s Fannie Gamble*, WALL ST. J., Aug. 1, 2008, at A13; Dick Army, *The Fan/Fred Bailout is a Scandal*, WALL ST. J., July 25, 2008, at A15; *Notable & Quotable*, WALL ST. J., July 25, 2008, at A15 (quoting former Treasury Secretary Lawrence Summers, criticizing the federal bailout of Fannie Mae and Freddie Mac); Review & Outlook, *Housing Bill Hammers Taxpayers*, WALL ST. J., July 24, 2008, at A14; Steve H. Hanke, *Interest Rates and the Dollar’s Value Are Related*, WALL ST. J., April 24, 2008, at A12; Tom Lauricella, Liz Rappaport & Joanna Slater, *Doubts on Rescue Plan Spur Fall in Dollar, Leap for Oil*, WALL ST. J., Sept. 23, 2008, at A1; *see also* sources cited *infra* note 116.



transactions.<sup>115</sup> As a consequence, the economy has continued to suffer even as unprecedented stimulus expenditures have been used to bail out and subsidize large enterprises.<sup>116</sup>

Second, it is noteworthy that the policy initiatives pursued since 2007 are dramatically different in some ways from the responses to previous credit and housing crises, including the last major credit and housing cycle.<sup>117</sup> As noted above, the last major downward cycle was in the 1980s and early 1990s. That cycle was similar to the current credit contraction in many ways, but the policy responses to date have been very different. The current approach is to bail out, subsidize and even expand large insolvent institutions as conduits for federal funding.<sup>118</sup> In contrast, in the late 1980s and early 1990s:

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115. See sources cited *supra* notes 1–3, 111–114. The results so far cannot be considered successful. See Ruth Simon, *Foreclosure Rescue Still Bogged Down*, WALL ST. J., Dec. 11, 2009, at A9; sources cited *supra* notes 1–3.

116. See sources cited *supra* notes 1–3, 111–114; see also Greg Hitt & Deborah Solomon, *Historic Bailout Passes as Economy Slips Slips Further*, WALL ST. J., Oct. 4, 2008, at A1; Jonathan G.S. Koppell, *Uncle Sam, Subprime Borrower*, WALL ST. J., July 26, 2008, at A9 (noting the very large expansion of public liabilities resulting from the Economic Stimulus Act of 2008); Brian Westbury, *The Fed's Interest Rate Dilemma*, WALL ST. J., April 30, 2008, at A17. Despite the lessons of the 1970s, "the [FRB] opened up the old playbook and cut rates aggressively when subprime loans blew up. This cemented higher inflation into place, crushed the dollar, pushed commodity prices up sharply, and created major problems in the energy, airline and agricultural marketplaces." *Id.* Mr. Westbury, chief economist at First Trust advisors, L.P., also warned that "[a] replay of the 1970s is likely unless the [FRB] has the courage to raise rates." See *id.* The *Wall Street Journal* noted that, although "no one has any idea of the real cost," the Economic Stimulus Act of 2008 could directly cost taxpayers upwards of a half trillion dollars, see *Housing Bill Hammers Taxpayers*, *supra* note 114; Lawrence B. Lindsey, former assistant to the president for economic policy, warned that the Economic Stimulus Act is full of "nonsensical provisions," see Lawrence B. Lindsey, *Hank Paulson's Fannie Gamble*, *supra* note 114; and Dick Armey, House majority leader from 1995 to 2002, noted that the ultimate cost could exceed \$1 trillion, see Dick Armey, *The Fan/Fred Bailout is a Scandal*, *supra* note 114. As it turned out, this was only the beginning. See Andrews, *supra* note 111; Lauricella, Rappaport & Slater, *supra* note 113. It is possible that the costs of these bailouts will be even higher than expected. See Associated Press, *Federal AIG Bailout to Exceed \$150B*, OKLAHOMAN, Nov. 11, 2008, at 6B (\$85 billion AIG bailout subsequently estimated to cost \$150 billion); Jackie Calmes, *Obama Asks Bush to Provide Help for Automakers*, N.Y. TIMES, Nov. 11, 2008, at A1; Sudeep Reddy & John D. McKinnon, *The Financial Crisis: A Big Unknown: Cost of Bailouts-Profit is Possible for Government if Firms do Well*, WALL ST. J., Sept. 18, 2008, at A3. Regarding Fannie and Freddie, see sources cited *supra* notes 35–37; regarding AIG, see also Holman W. Jenkins, Jr., *The Ugly AIG Post-Mortem*, WALL ST. J., Nov. 25, 2009, at A17; Liam Plevin, Matthew Karnitschnig & Deborah Solomon, *U.S. Revamps Bailout of AIG—Taxpayers Exposed Greater Risk in New Plan; \$30 Billion More from TARP Funds*, WALL ST. J., May 2, 2009, at A1.

117. See generally Harrell, *The Subprime Credit Crisis—the Perfect Credit Storm?*, *supra* note 97; compare recent policy initiatives with the response to the banking and deposit insurance crises of the 1980s and early 1990s, described in sources cited *supra* notes 15 and 17.

118. Considering that the cost of bailing out Fannie Mae and Freddie Mac may now exceed \$400

insolvent institutions were shut down amid promises that “never again” would such losses be placed on taxpayers; traditional measures such as higher capital standards, prompt corrective action, and mark-to-market accounting were heralded as essential to preventing a recurrence; and insolvent institution-affiliated parties were pursued vigorously through an aggressive federal enforcement effort.<sup>119</sup> The media drumbeat reached almost a frenzy in its outrage at the prospect that the crisis might cost as much as \$150 billion.<sup>120</sup>

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billion, *see* sources cited *supra* notes 35–37, adding in the \$700 billion bailout bill passed in late September, 2008, *see* sources cited *infra* note 145, and counting other assorted 2008 financial bailouts, *see* sources cited *infra* notes 144–147, the total cost of the 2008 bailouts alone could exceed several trillion dollars. *See also* Andrews, *supra* note 111; David M. Herszenhorn, *Administration Is Seeking \$700 Billion for Wall St. in Possible Record Bailout*, N.Y. TIMES, Sept. 21, 2008, at 1; *supra* note 3. With the \$700 billion September, 2008 bailout, the previous \$350 billion for the Department of Housing and Urban Development, \$200 billion or more for Fannie Mae and Freddie Mac in the Economic Stimulus act of 2008, *see* sources cited *infra* notes 144–147, and many billions more for other bailouts such as Bear Stearns and AIG, *see* sources cited *supra* note 115, not to mention the (currently unknown) needs of the Federal Deposit Insurance Corporation (FDIC), the 2008–2009 bailouts alone may be on the order of a magnitude of some ten to twenty times the size of the roughly \$150 billion bailout of the federal deposit insurance funds in the 1980s. *See* James R. Barth, *THE GREAT SAVINGS AND LOAN DEBACLE* 1, 69–79 (1991); sources cited *supra* notes 15–17; *see also* Lindsey, *Hank Paulson’s Fannie Gamble*, *supra* note 114; Armeiy, *The Fan/Fred Bailout is a Scandal*, *supra* note 113; Bertrand Horwitz, *If IndyMac, Why Not Fannie and Freddie?*, WALL ST. J., Aug. 7, 2008, at A12 (“Is it possible that the attention of regulators and Congress can be deflected by lobby size?”); Holman W. Jenkins, Jr., *Washington Loves Bank Investors*, WALL ST. J., July 23, 2008, at A15 (noting that the federal government is now seeking to protect and reassure private investors because their capital is needed, but this procedure is an uphill battle with anyone who remembers the government’s treatment of thrifts in the 1980s); Holman W. Jenkins, Jr., *Why Fannie and Freddie Will Survive (Alas)*, WALL ST. J., Aug. 27, 2008, at A13 (noting federal efforts to protect some but not all private investors while providing public financial support to the GSEs); Review & Outlook, *When Henry Met Fannie*, WALL ST. J., Aug. 19, 2008 at A16; Review & Outlook, *Housing Bill Hammers Taxpayers*, *supra* note 114. On the risks of using public money to bail out private enterprises, *see also* William Voegeli, *Keep the Capitol out of Capitalism; Rather Than Trying to Fix the Markets, Washington Should Just Lay Down Some Clear Rules*, L.A. TIMES OPINION, July 27, 2008, at M9; Robert Novak, *The High Cost of Cronyism*, OKLAHOMAN, July 19, 2008, at 9A; Dick Armeiy, *Congress and the Countrywide Scandal*, WALL ST. J., June 18, 2008, at A15; and Review & Outlook, *Fannie Mae Ugly*, WALL ST. J., July 12, 2008, at A10. There are obvious problems with the fairness of this selective bailout approach. *See* Tom Brokaw, *Lots of People Could Use a Cash Infusion*, WALL ST. J., Sept. 24, 2008, at A27. Despite these losses, the roles of the GSEs and other federally-funded housing programs have been dramatically expanded. *See* sources cited *supra* notes 3, 35–37; Stephen F.J. Ornstein, Matthew S. Yoon, David A. Tallman & John P. Holahan, *The Economic Stimulus Act of 2008*, 61 CONSUMER FIN. L.Q. REP. 942 (2007); Stephen F.J. Ornstein, Mathew S. Yoon, David A. Tallman & John P. Holahan, *The Housing and Economic Recovery Act of 2008*, 61 CONSUMER FIN. L.Q. REP. 944 (2007).

119. *See* sources cited *supra* notes 15–17; *see also* Harrell, *supra* note 97, at 628 n.1 (citing various commentaries and the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA)). Even the Bankruptcy Code was amended to assure that the targets of this effort could not be relieved of their debts to society. *See* 11 U.S.C. §§ 101(33), 523(a)(7), (11)–(13), (19). Today, as noted below, the public is similarly incensed, but the public policy treatment of insolvent institutions and their

As noted, things are very different this time.<sup>121</sup> Fannie and Freddie continue to operate as giant thrifts, generating the same kinds of losses that sank the traditional thrift industry in the 1980s; instead of being shut down, they have received ever-larger federal subsidies and are being encouraged to expand.<sup>122</sup> Over the past three years the potential cost of Fannie and Freddie has quickly ratcheted, from assurances of solvency to deficits of \$25 billion, \$100 billion, then \$200 billion, and finally \$400 billion, before becoming officially unlimited last year; some have estimated that ultimately these bailouts could increase the U.S. national debt by \$1 trillion or

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insiders is quite different. While the obligatory federal investigations have begun, *see, e.g.*, Lara Jakes Jordon, *FBI investigates 4 at Core of Collapse*, OKLAHOMAN, Sept. 24, 2008, at 1B; Thomas M. Gallagher, Travis P. Nelson & Michael A. Schwartz, *Federal Authorities Launch Investigations into the Subprime Meltdown*, 61 CONSUMER FIN. L.Q. REP. 935 (2007), Fannie and Freddie remain intact and geared for further expansion; AIG alone was aided at a cost roughly equal to the cost of the entire 1980s thrift and deposit insurance crisis, *see Federal AIG Bailout to Exceed \$150B*, *supra* note 116; the *Wall Street Journal* urged that insolvent banks be kept afloat with infusions of federal capital rather than closed, *see Review & Outlook, The Paulson Sale*, WALL ST. J., Sept. 24, 2008, at A1; the FRB has extended its supervision (and safety net) to troubled investment banks, *see Sudeep Reddy, Bailout Plan Puts All Eyes on the Fed*, WALL ST. J., Sept. 23, 2008, at A3; other industries lined up for assistance, *see Elizabeth Williamson, Auto Finance Firms Seek a Hand*, WALL ST. J., Sept. 23, 2009, at A2; and the rules governing bank ownership have been loosened rather than tightened, *see Peter Lattman & Damian Paletta, Funds Get Freer Hand in Buying Bank Stakes*, WALL ST. J., Sept. 23, 2008, at A1; *see also* sources cited *supra* notes 35–37, 116.

120. *See* sources cited *supra* notes 15, 17. This is a figure that seems a relative pittance compared to current bailout efforts, which have been accepted by most of the media with nary a peep. *But see* Karl Rove, *Voter Anger Is Building over Deficits*, WALL ST. J., Nov. 27, 2009, at A19.

121. *Compare* sources cited *supra* notes 15–17 with sources cited *supra* notes 118–119. In fact, we may be experiencing the beginning of a replay of the 1970s, rather than the 1980s and 1990s, given the aggressive monetary policy of the past few years. *See supra* notes 25–29; Guha, *Greenspan Warns of More Bank Bailouts*, *supra* note 114; Westbury, *The Fed's Interest Rate Dilemma*, *supra* note 116. As result, the deposit insurance system may need to be rescued again. *See* Damian Paletta & Jessica Holzer, *FDIC Weighs Tapping Treasury as Funds Run Low—Short-Term Loans Might be Needed After a Bank Failure*, WALL ST. J., Aug. 27, 2008, at A11; Marcy Gordon, *Bank Failures Take Financial Toll on FDIC Deposit Insurance Feels Pinch*, OKLAHOMAN, Sept. 17, 2008, at 3B. Another result will be a more highly concentrated and heavily-regulated financial system. *See* Harrell, *supra* note 8, at 627–28; Harrell, *supra* note 78; *see also* sources cited *supra* note 118.

122. *See* sources cited *supra* note 3; Jenkins, *supra* note 33 (“In effect, we are reliving the S&L crisis, with two giant S&Ls gambling on survival with taxpayer funds while politicians summon the will to act”). The GSEs are not, of course, the only government-sponsored housing and credit-related entities. There are also federal agencies such as the Department of Housing and Urban Development (HUD) and the FDIC. As noted, these agencies are having their own problems. *See* Damian Paletta & Jessica Holzer, *FDIC Weighs Tapping Treasury as Funds Run Low—Short-Term Loans Might be Needed After a Bank Failure*, WALL ST. J., Aug. 27, 2008 at A11; sources cited *supra* notes 35–37. But as quasi-private enterprises, the GSEs had a financial structure that was more visible to the public.

more.<sup>123</sup> In attempting to resuscitate the housing market, the GSEs have been joined by the FRB, which at the time of this writing has expanded its liabilities to \$2.2 trillion (including over a \$1 trillion to purchase long-term mortgage-related securities); we are now treated to the spectacle of the FRB acting as a giant government thrift institution, with all of the risks that entails.<sup>124</sup> Additionally, in late 2008 Congress created a separate \$700 billion bailout fund, which was used to nationalize (and subsidize) large segments of the insurance and auto industries.<sup>125</sup> The contrasting treatment of the affected parties in the 1980s could not be more dramatic.<sup>126</sup>

An obvious reason for this difference is that this time federal policy makers want to expand rather than reduce federal expenditures and subsidies to various recipients, some of which have been partly (or wholly) nationalized, in order to target the benefits while supplying credit in response to the Great Credit Contraction, related problems in the housing market, and economic problems including

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123. See sources cited *supra* notes 35–37, 105–106, 116–118; James R. Hagerty, Ruth Simon & Damian Paletta, *U.S. Seizes Mortgage Giants- Government Ousts CEO's of Fannie, Freddie; Promises up to \$200 Billion in Capital*, WALL ST. J., Sept. 8, 2008, at A1. As noted, purely private entities are also being bailed out; see Matthew Karnitschnig, Deborah Solomon, Liam Plevin & Jon E. Hilsenrath, *U.S. to Take Over AIG in \$85 Billion Bailout; Central Banks Inject Cash as Credit Dries Up-Emergency Loan Effectively Gives Government Control of Insurer; Historic Move Would Cap 10 Days that Reshaped U.S. Finance*, WALL ST. J., Sept. 17, 2008, at A1; *supra* note 116. The bailouts have shown a marked propensity to grow over time. See sources cited *supra* notes 35–37, 106; Solomon, Hagerty & Crittenden, *Strains Mount on Bailout Plans—American Express Gets Quicker Access to U.S. Cash; Fannie Mae May Need More Help*, *supra* note 112. As noted, the 2008–2009 bail-outs, unlike the treatment of banks and thrifts in the 1980s, left the rescued institutions and their management largely intact, simply using federal money to recapitalize the institutions. See sources cited *supra* note 108, 118, 119; Peter J. Wallison, *How Paulson Would Save Fannie Mae*, WALL ST. J., Sept. 12, 2008, at A17.

124. See sources cited *supra* notes 71, 122, 123. Except, of course, that the FRB essentially manufactures its own money. But see sources cited *supra* note 23.

125. See sources cited *infra* notes 144–147. A primary exception, of course, was Lehman Brothers Holdings, Inc. See Susanne Craig, Jeffrey McCracken, Jon Hilsenrath & Deborah Solomon, *AIG, Lehman Shock Hits World Markets—Focus Moves to Fate of Giant Insurer After U.S. Allows Investment Bank to Fail; Barclay's in Talks to Buy Core Lehman Unit*, WALL ST. J., Sept. 16, 2008, at A1.

126. See sources cited *supra* notes 118, 119. Though it is usual to simply place the blame on such things as corporate greed and lax oversight, today (as in the 1980s) this has had its share of adherents, apparently including both 2008 presidential candidates. See Gerald F. Seib, *Wall Street's Woes Challenge Both Candidates*, WALL ST. J., Sept. 16, 2008, at A6; Review & Outlook, *McCain and the Markets*, WALL ST. J., Sept. 17, 2008, at A26; Nick Timiraos, Elizabeth Holmes & Michael M. Phillips, *Candidates Promise Broad Changes for Wall Street—McCain and Obama Have Similar Plans to Address Crisis*, WALL ST. J., Sept. 17 2008, at A4; Review & Outlook, *McCain's Scapegoat*, WALL ST. J., Sept. 19, 2008, at A22.

the consequent rise in unemployment.<sup>127</sup> Thus, instead of an emphasis on preventing another credit bubble, the emphasis is on seeking to recreate one, for example using targeted federal funding to re-inflate the housing and credit boom. But the mechanisms in use—various forms of FRB and taxpayer funding for large, high-profile institutions—mean that much of the money is being funneled into the stock market and government-related securities (as well as gold, commodities, and overseas markets<sup>128</sup>). The government pumps zero (or very low) cost funds into large financial institutions, which then use the money to fund proprietary trading activities, including the purchase of stocks and government-backed securities. This bolsters the profitability of these institutions, helps the government fund its obligations, and creates popular new bubbles in these markets, but so far has little impact on the broader economy.

These problems have been accompanied by a flight of the domestic and international capital needed to support U.S. consumer credit markets and a broader economic recovery.<sup>129</sup> These broader markets

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127. See Liam Plevin, Matthew Karnitschnig & Deborah Solomon, *U.S. Revamps Bailout of AIG—Tax-Payers Exposed to Greater Risk in New Plan: \$30 Billion More from TARP Funds*, WALL ST. J., Mar. 2, 2009, at A1; Deborah Solomon, Jon Hilsenrath & Damian Paletta, *U.S. Plots New Phase in Banking Bailout*, WALL ST. J., Jan. 17, 2009, at A1; Jon Hilsenrath, Serena Ng & Damian Paletta, *supra* note 111; Carrick Mollenkamp, Mark Whitehouse & Neil Shah, *Lending Among Banks Freezes*, WALL ST. J., Sept. 17, 2008, at A1; Deborah Solomon, Michael Corkery & Liz Rappaport, *Mortgage Bailout Is Greeted With Relief, Fresh Questions*, WALL ST. J., Sept. 9, 2008, at A1; Greg Hitt & Nick Timiraos, *Housing Looms Larger*, WALL ST. J., Sept. 9, 2008, at A8; Suddep Reddy, *The Financial Crisis: Fed Lent \$121 Billion on Week*, WALL ST. J., Sept. 19, 2008, at A6; Joellen Perry, *The Financial Crisis: Central Banks Pump Out Cash—Fed Sends Dollars to its Foreign Peers in Bid to Pare Rates*, WALL ST. J., Sept. 19, 2008, at A4; Jon Hilsenrath, *The Financial Crisis: Behind the Fed Moves, and What's Next*, WALL ST. J., Sept. 19, 2008, at A4. Unfortunately, as noted *supra* note 2 and *infra* at notes 128–129, for many consumers the results have been less than successful. See, e.g., Conor Dougherty, *Downturn Weighs on Poor*, WALL ST. J., Sept. 29, 2009, at A3; Justin Lahart, *Economy Still Bleeding Jobs*, WALL ST. J., Jan. 9, 2010, at A1; Reich, *supra* note 74.

128. See Associated Press, *Investors See Gold Upsurge as Shield Against Dollar*, OKLAHOMAN, Nov. 12, 2009, at 1B; sources cited *supra* notes 23–28. Partly as a result, the volatility has spread to foreign markets. See, e.g., Brian Blackstone, Tom Lauricella & Neil Shak, *Global Markets Shudder*, WALL ST. J., Feb. 5, 2010, at A1; Charles Forelle & Susanne Craig, *Debt Deals Haunt Europe*, WALL ST. J., Feb. 22, 2010, at A1.

129. See sources cited *supra* note 128; see also James Grant, Essay, *The Confidence Game*, WALL ST. J., Oct. 18, 2008, at W1 (citing a lack of confidence in federal financial policies); Holman W. Jenkins, Jr., *Are We Running Out of Rescue Cash?*, WALL ST. J., Sept. 17, 2008, at A25; Tom Lauricella, Liz Rappaport & Annelena Lobb, *Mounting Fears Shake World Markets as Banking Giants Rush to Raise Capital*, WALL ST. J., Sept. 18, 2008, at A1, A14; Solomon, Corkery & Rappaport, *Mortgage Bailout Is Greeted With Relief, Fresh Questions*, *supra* note 127. The need to attract international capital ultimately

remain largely frozen, impervious to federal funding efforts focused on subsidies to a few large entities.<sup>130</sup> These broader markets are more dependent on private capital and the routine enforceability of credit contracts and mortgage liens, an issue put in doubt by the public policy assaults on subprime consumer lending.<sup>131</sup>

Thus, the 2008–2009 solutions have failed to address the issues and problems created by the countervailing restrictions (at both state and federal levels) on subprime mortgage lending.<sup>132</sup> In effect, the consumer credit system has become a bottleneck that fails to pass through federal monetary and fiscal stimuli to the broader economy. As a result, the 2008–2009 stimulus and bailout efforts have largely failed to resuscitate the economy.<sup>133</sup> The large public expenditures, institutional bailouts, subsidies on an unprecedented scale, and massively accommodative FRB monetary policy<sup>134</sup> have avoided the

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may place constraints on domestic political considerations. See Zachary Karabell, *America and the New Financial World*, WALL ST. J., Oct. 6, 2008, at A19; Jeff Bater, *Foreigners Buy Fewer U.S. Assets—Net Purchases in October Came in at \$8.3 Billion*, WALL ST. J., Dec. 16, 2009, at C8.

130. See sources cited *supra* note 127; see also sources cited *supra* notes 35–37, 118–123; Review & Outlook, *The Next Bailout: Detroit*, WALL ST. J., Aug. 22, 2008, at A14 (noting the 2008 plans of Detroit automaker to seek federal funding of roughly \$40 billion, and summarizing the corporate and prospective federal agency bailouts apparent to that date in 2008, including the FDIC (amount unknown), Bear Stearns (\$29 billion), HUD and the FHA (\$350 billion), the student loan program (amount unknown), FHA Secure (up to \$50 billion), and Fannie Mae/Freddie Mac (now estimated at \$200 billion, or more)). To this was added the \$700 billion bailout for Wall Street and other financial institutions. See Herszenhorn, *supra* note 117, at 1. Then there is the increase in the AIG bailout to \$150 billion or more and subsidies to the auto industry and others. See sources cited *supra* note 116. Then there is the \$2 trillion-plus FRB balance sheet, and the subtle subsidy to the major banks that are borrowing from the FRB for almost nothing and relending to the Treasury at a healthy margin. See sources cited *supra* notes 71–73, 104, 122–123; Gerald P. O'Driscoll, Jr., *Obama vs. the Banks*, WALL ST. J., Dec. 17, 2009, at A27. The implications go well beyond the potential for increased demands on taxpayers. See Gerald P. O'Driscoll, Jr., *Washington Is Quietly Repudiating Its Debts*, WALL ST. J., Aug. 22, 2008, at A15; Holman W. Jenkins, Jr., *Are We Running Out of Rescue Cash?*, WALL ST. J., Sept. 17, 2008, at A25; David Broder, *Staggering Deficit Provides a Sobering Dose of Reality*, OKLAHOMAN, Sept. 15, 2008, at 10A; sources cited *supra* note 112. And, so far at least, it has simply not worked to revive the private credit markets. See Driscoll, *supra*; David Streitfeld, *Rates Are Low, But Banks Balk at Refinancing*, N.Y. TIMES, Dec. 13, 2009, at 1; Forbes, *supra* note 107, at 16; sources cited *supra* note 127.

131. See *supra* Part I.B.7.

132. See *supra* Part I.B.7.

133. See sources cited *supra* notes 25, 33, 107, 111–112, 129, 130; Vernon L. Smith, *There's No Easy Way out of the Bubble*, WALL ST. J., Oct. 9, 2008, at A17.

134. See sources cited *supra* notes 111–112, 114–116, 130; Manuel Hinds, *It's Time for Banks to Put Their Chips on the Table*, WALL ST. J., Oct. 9, 2008, at A15 (noting huge injections of liquidity by the FRB).

risks of a systemic liquidity crisis that threatened the banking system,<sup>135</sup> but have not prevented the Great Credit Contraction, or the resulting recession, or addressed related problems in the housing, credit, and mortgage markets.<sup>136</sup>

As noted, this is because the 2008–2009 stimulus efforts are largely misdirected and fail to address the fundamental problems afflicting the economy and the credit markets: an unworkable system of consumer protection laws, and a lack of confidence in the enforceability of consumer credit contracts and mortgage liens. We finally have reached a tipping point: the regulatory, statutory, and judicial restraints on origination and enforcement of consumer debts and mortgage liens have overcome the basic strengths of the U.S. legal system, so as to impair confidence in the American rule of law. The result has been a flight of capital from U.S. mortgage markets, directly related to the onerous consumer protection laws and regulations directed at subprime home mortgage lending.<sup>137</sup> This is the culmination of a trend dating back some forty years, consisting of an ever-increasing umbrella of complex federal consumer protection laws and regulations being imposed on top of an unworkable patchwork of non-uniform state laws.<sup>138</sup> In the past few years this trend accelerated, first in response to the 1993–2006 expansion of consumer credit and then in response to its contraction, and in fact

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135. See Deborah Solomon, Liz Rappaport, Damian Paletta & Jon Hilsenrath, *Shock Forced Paulson's Hand—A Black Wednesday on Credit Markets; 'Heaven Help us All'*, WALL ST. J., Sept. 20, 2008, at A1; see also sources cited *supra* notes 111–112, 114–116, 130; Deborah Solomon, Damian Paletta & Greg Hitt, *U.S. Seals Bailout Deal*, WALL ST. J., Sept. 29, 2008, at A1.

136. See Ruth Simon & Michael Corkery, *Problem of Home Prices Remains*, WALL ST. J., Oct. 15, 2008, at A3; Peter S. Goodman, *But Will It All Work?*, N.Y. TIMES, Sept. 21, 2008, at 1; Justin Lahart, Timothy Aepfel & Conor Dougherty, *Credit Crisis Darkens U.S. Outlook*, WALL ST. J., Sept. 9, 2008, at A8; Michael Corkery, *Housing's Biggest Woes Are Left Untreated*, WALL ST. J., Sept. 8, 2008, at A14; see also sources cited *supra* notes 2, 111–116, 130. Public officials seem perplexed and unsure what to do next. See *supra* note 13; Tom Raum, *Analysis: Officials Running Out of Solutions*, OKLAHOMAN, July 16, 2008, at 3B (“The nation’s leaders are running out of answers to America’s economic crisis.”).

137. See *supra* Part I.B.7; see also Lampe, Miller & Harrell, *supra* note 97, at 567–69. Indeed, some of the proposals urged and solutions adopted in response to the current crisis may make things worse, for example, by discouraging extensions of consumer credit and suggesting an intent to increasingly impair the legal rights of mortgage creditors. See discussion below, including sources cited *infra* notes 141–166 and accompanying text.

138. See sources cited *supra* note 137.

there was a surge in such measures after the Great Credit Contraction began in 2007, with both state and federal laws and regulations becoming even more onerous from the perspective of consumer mortgage lending.<sup>139</sup> This is a prescription for a credit crisis and an economic contraction, even as the FRB has pumped unprecedented funding into the system and major institutions have received massive bailouts and subsidies. The result has been a world-wide loss of confidence in the enforceability of U.S. credit contracts, in the midst of a stock market boom and near-zero interest rates, a dramatic reversal from our previous economic history.

Sadly, the Great Credit Contraction and related economic problems are largely self-inflicted injuries, resulting from misguided consumer credit laws and regulations (in conjunction with monetary policy errors and federal housing policy), that have created an untenable legal environment for residential mortgage transactions.<sup>140</sup> Moreover, legal non-uniformity and interference with judicial remedies at the state level have increased dramatically.<sup>141</sup> Together, these developments significantly discourage home mortgage lending and investment, acting as a counter to efforts of the FRB and policy makers to reinvigorate the housing and credit markets.<sup>142</sup> And, as

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139. See sources cited *supra* note 3. See also sources cited *supra* note 137; *supra* Part I.B.7; sources cited *supra* notes 78, 98–99. A review of any recent *Annual Survey of Consumer Financial Services Law*, in *The Business Lawyer* or any issue of the *Consumer Finance Law Quarterly Report* will amply illustrate this point. For merely one example, regulation under the federal Truth in Lending Act has gone well beyond its original purpose requiring truthful disclosure, to embrace onerous substantive consumer protection provisions with extensive restrictions backed by severe sanctions. See sources cited *infra* notes 143–146. Of course, in this respect, the FRB is merely reflecting the will of Congress, as it is essentially required to do. But that does not fix the problem.

140. See Stephen F.J. Ornstein, Matthew S. Yoon, David A. Tallman & John P. Holahan, *The Current Residential Mortgage Market Landscape in the United States*, 61 CONSUMER FIN. L.Q. REP. 891 (2007) (describing many of the measures noted here); Stephen F.J. Ornstein & Matthew S. Yoon, *Update on Federal Anti-Predatory Lending Legislative Efforts*, 61 CONSUMER FIN. L.Q. REP. 620 (2007). See also sources cited *supra* note 3.

141. See Donald C. Lampe, Fred H. Miller & Alvin C. Harrell, *Introduction to the 2009 Annual Survey of Consumer Financial Services Law*, 64 BUS. LAW. 465, 467 (2009); Amir Efrati, *Foreclosure Challenges Raise Questions About Judicial Role*, WALL ST. J., Dec. 24, 2009, at A15.

142. See; Guha, *Greenspan Warns of More Bank Bail-Outs*, *supra* note 114; sources cited *supra* note 71. See also Harrell, *supra* note 97; Sudeep Reddy, *Bernanke Defends Policy of Low Rates*, WALL ST. J., Aug. 23, 2008, at A3. This has obvious implications for bank management, which may believe there is good reason for caution and has a fiduciary duty to protect the assets of the bank. The result is a simple credit crunch. See Streitfeld, *supra* notes 112, 130. As noted, the subsequent policy responses probably are making things worse. See Review & Outlook, *Banker Baiting 101*, WALL ST. J., Dec. 15,



noted again below, many of the current “solutions” are making matters even worse.<sup>143</sup>

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2009, at A20. *See also* sources cited *supra* note 3. In addition, there is apparently some tension between banking regulators that favor increased credit liberality and the FDIC, which is responsible for the consequences. Peter A. McKay, *FDIC Presses Bank Regulators to Use Warier Eye—Dow Slides 180.51 as Fannie, Freddie Drag Down Market*, WALL ST. J., Aug. 19, 2008, at C1. In addition, it has been argued that similar pressures to expand lending may have contributed to the current crisis. *See* George Will, *More Corporate Welfare?*, OKLAHOMAN, Sept. 21, 2008, at 14A (“Politics produced Fannie Mae.”); Review & Outlook, *Fannie Mae’s Patron Saint*, WALL ST. J., Sept. 9, 2008, at A24; Harrell, *supra* note 97, at 628; Lampe, Miller & Harrell, *supra* note 97, at 563–64. Others have noted the similar effects of related mandates, such as the Community Reinvestment Act (CRA), in creating the current crisis. *See supra* Part I.B.4; Charles Krauthammer, *Whatever It Takes*, OKLAHOMAN, Sept. 26, 2008, at 8A (“It lies at the root of our current calamity.”); Review & Outlook, *A Mortgage Fable*, WALL ST. J., Sept. 22, 2008, at A22 (listing the CRA as one of the federal policies promoting easy mortgage credit and contributing to the 2008 “meltdown,” along with FRB monetary policy; Fannie Mae and Freddie Mac; the “credit-rating oligopoly,” banking regulators; and corporate bailouts such as the “Bear Stearns rescue.”). And, of course, there will always be a role for irresponsibility driven by greed and short-term expediency. Given the obvious role of lax credit standards in contributing to the current problems, it is legitimate to question whether it is appropriate for federal policy and regulation to provide further incentives for such behavior. Still, that has been a part of federal policy for many years. *See id; supra* Parts I.B.2, 3, 4, 6.

143. *See* Kara Scannell, Phred Dvorak, Joann S. Lublin & Elizabeth Williamson, *Rescue Plan Stirs Calls for Deeper Regulation*, WALL ST. J., Sept. 24, 2008, at A1; Bob Davis, Damian Paletta & Rebecca Smith, *Unraveling Reagan: Amid Turmoil, U.S. Turns Away from Decades of Deregulation*, WALL ST. J., July 25, 2008, at A1. As noted, this apparently included both 2008 presidential candidates. *See supra* note 126; Nick Timiraos, Elizabeth Holmes & Michael M. Phillips, *Candidates Promise Broad Changes for Wall Street*, WALL ST. J., Sept. 17, 2008, at A4. Indeed, the consistent “stimulus” policies throughout 2008–2009 can be fairly called bipartisan, differing largely in the amounts (and in some cases the identity of the recipients). Because of this basic consistency, it is fair to describe the current approach as the Bush-Paulson-Bernanke-Obama-Geithner program. It is appropriate to note again that many of these measures significantly constrain credit availability and/or increase the scope of the potential public liability for private financial losses and that this is a sharp reversal from the financial reforms of the 1980s and 1990s, which generally were intended to enhance private credit availability and reduce public liabilities in response to the deposit insurance crises of that period. *See* sources cited *supra* notes 3, 118–119; Harrell, *supra* note 4, at 628. *See also supra* notes 15, 17. As noted above, the Economic Stimulus Act of 2008 alone could cost taxpayers half a trillion to one trillion dollars or even more. *See* sources cited *supra* notes 116–118, 128–130. More recent initiatives conceivably could double this cost. *See* Herszenhorn, *supra* note 9. Other proposals, such as that from the Treasury to encourage banks to issue so-called “covered bonds” (which may effectively bring the assets sold and securitized by banks within the umbrella of federal deposit insurance, which is already strained) may create even more public liabilities. *See, e.g.,* Deborah Solomon, *U.S. Pushes a European Model to Help Banks Make Home Loans—‘Covered Bonds’ May Lure Investors Wary of Defaults*, WALL ST. J., June 17, 2008, at A3; Review & Outlook, *Mr. Paulson’s New Bonds*, WALL ST. J., July 31, 2008, at A14; Paletta & Holzer, *FDIC Weighs Tapping Treasury as Funds Run Low—Short-Term Loans Might be Needed After a Bank Failure*, *supra* note 121; *see also* sources cited *supra* notes 35–37, 142; *infra* Part III.

### III. RECENT AND PROPOSED SOLUTIONS

#### A. 2008–2009 Legislation and Regulations

In 2008–2009 the American economy was literally flooded with additional state and federal policy measures directed at consumer mortgage credit. Among these,<sup>144</sup> the Economic Stimulus Act of 2008 increased the GSE lending limits while extending federal guaranties to cover their liabilities, and provided \$350 billion more for FHA lending programs as well as other subsidies for assorted federal programs.<sup>145</sup> This was followed by the Housing and Economic Recovery Act of 2008 (HERA),<sup>146</sup> and later by the \$700 billion Emergency Economic Stabilization Act of 2008.<sup>147</sup> A stated purpose of such measures was to resuscitate mortgage lending, which sharply contracted beginning in 2007, resulting in a larger credit crunch.<sup>148</sup>

Almost simultaneously, however, a barrage of other state and federal requirements was being implemented for the apparent purpose of reducing the availability of subprime mortgage credit.<sup>149</sup> As noted above, examples include regulatory initiatives such as the Interagency Guidance on Nontraditional Mortgage Product Risks, the Interagency Statement on Subprime Mortgage Lending,<sup>150</sup> and the

144. See Lampe, Miller & Harrell, *supra* note 141, at 468; Julie R. Caggiano, Theresa G. Franzén & Jennifer L. Dozier, *Mortgage and Predatory Lending Law Developments*, 64 BUS. LAW. 517 (2009).

145. Economic Stimulus Act of 2008, Pub. L. No. 110-185, 122 Stat. 613 (2008); see also sources cited *supra* note 143. See generally Stephen F.J. Ornstein, Matthew S. Yoon, David A. Tallman & John P. Holahan, *The Economic Stimulus Act of 2008*, 61 CONSUMER FIN. L.Q. REP. 942 (2007); Caggiano, Franzén & Dozier, *supra* note 144.

146. Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, 122 Stat. 2654 (2008). See generally Ornstein, Yoon, Tallman & Holahan, *The Housing and Economic Recovery Act of 2008*, 61 CONSUMER FIN. L.Q. REP. 944 (2007).

147. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765 (2008).

148. See sources cited *supra* notes 1–3, 111–142. The discussion below also notes some of the risks of these measures.

149. See Lampe, Miller & Harrell, *supra* note 144, at 468; sources cited *supra* note 148. In addition to these sources and the discussion below, see Caggiano, Franzén & Dozier, *supra* note 144; Richard E. Gottlieb & Andrew McGuinness, *Subprime Lending as Public Nuisance: Casting Blame Mortgage on Lenders and Wall Street for Inner City Blight*, 62 CONSUMER FIN. L.Q. REP. 4 (2008); Lynette Hotchkiss, *A Loan by Any Other Name- The Advent of the "Rate Spread" Home Loan*, 62 CONSUMER FIN. L.Q. REP. 653; Lynette Hotchkiss & Sharon L. Bangert, *Broker Beware*, 62 CONSUMER FIN. L.Q. REP. 87 (2008); Harrell, *supra* note 97, at 630–31; Lampe, Miller & Harrell, *supra* note 97, at 567–69.

150. See Lampe, Miller & Harrell, *supra* note 143, at 468. See, e.g., Stephen F.J. Ornstein & Matthew S. Yoon, *Interagency Guidance on Nontraditional Mortgage Products Risks*, 61 CONSUMER FIN. L.Q.

FRB's 2008 revisions to Regulation Z,<sup>151</sup> all intended to curtail predatory practices but also having an adverse effect on legitimate subprime mortgage lending.<sup>152</sup> These federal measures were imposed on top of an expanding range of state "anti-predatory lending" laws that had the same effect,<sup>153</sup> and, when these laws and regulations succeeded in restricting subprime credit availability and left consumers unable to refinance or buy homes, housing demand and prices sagged, and ultimately foreclosures surged.<sup>154</sup> Some states and courts then responded with measures designed to impede foreclosure,<sup>155</sup> which again made this problem worse.<sup>156</sup> State and federal laws and regulations that impose fiduciary-like duties on mortgage lenders to protect borrowers are another example, which have the effect of encouraging borrowers to default and then blame their lender.<sup>157</sup> It is not clear why policy makers think that imposing these onerous new burdens, legal risks, compliance and litigation costs and liabilities on creditors, and restrictions on the origination and enforcement of mortgage loans will enhance the availability and affordability of credit.<sup>158</sup> In addition, the interference with judicial

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REP. 161 (2007); Stephen F.J. Ornstein, David A. Tallman & John P. Holahan, *Interagency Statement on Subprime Mortgage Lending*, 61 CONSUMER FIN. L.Q. REP. 176 (2007).

151. See Caggiano, Franzén & Dozier, *supra* note 144; Hotchkiss, *supra* note 148; Hotchkiss & Bangert, *supra* note 149.

152. See sources cited *supra* notes 148–150. See also Lampe, Miller & Harrell, *supra* note 144, at 468; Stephen F.J. Ornstein, Matthew S. Yoon, David A. Tallman & John P. Holahan, *Final Rule Amending the Home Mortgage Provisions of Regulation Z*, 61 CONSUMER FIN. L.Q. REP. 932 (2007); Stephen F.J. Ornstein & Matthew S. Yoon, *Proposed FRB Mortgage Lending Regulations*, 61 CONSUMER FIN. L.Q. REP. 616 (2007). While some maintain that predatory lending caused the current crisis, others have responded that there is no evidence to support this. See, e.g., Krauthammer, *supra* note 142 ("Were there some predatory lenders? Of course. But only a fool or a demagogue . . . would suggest that this is a major part of the problem.").

153. See *supra* Part I.B.7; sources cited *supra* note 144 and *infra* note 158.

154. See Constance Mitchell Ford, *Foreclosures Continue to Put a Damper on Home Prices*, WALL ST. J., Nov. 11, 2009, at A6; *The Year in Foreclosures*, *supra* note 2; sources cited *supra* note 1–3, 107–109.

155. See Symposium, *Debt Collection, Mortgage Law, and Foreclosure*, 63 CONSUMER FIN. L.Q. REP. 221 (2009); Efrati, *supra* note 141.

156. See Aaron Byrkit, *Reforming Mortgage Disposition: A Tool for Tempering the Financial Meltdown*, 63 CONSUMER FIN. L.Q. REP. 275, 276–77 (2009).

157. See Bennet S. Koren, *Suitability and HOEPA*, 61 CONSUMER FIN. L.Q. REP. 201 (2007).

158. See e.g., Harrell, *supra* note 78. See also Lampe, Miller & Harrell, *supra* note 97, at 567–69; *State Law Developments*, 61 CONSUMER FIN. L.Q. REP. 390 (2007); Fred H. Miller, Jeffrey I. Langer, Donald C. Lampe & Alvin C. Harrell, *Introduction to the 2007 Annual Survey of Consumer Financial Services Law*, 62 BUS. LAW. 553 (2007); sources cited *supra* note 109.

processes and standards in some states has cast doubt on the basic rule of law, undermining the legal pillars of mortgage credit.<sup>159</sup> It takes only a few such developments (along with the seemingly inevitable political posturing that accompanies such measures) to impair confidence in an entire credit system. Moreover, once the damage has been done it is not easy to repair. No wonder private mortgage finance has all but collapsed, despite federal spending and credit programs of such magnitude as to create a new range of additional problems and financial bubbles.<sup>160</sup>

All of this has largely escaped public and media notice.<sup>161</sup> Perhaps there is a natural tendency to ignore facts that don't support one's policy agenda, and perhaps only specialized lawyers can fully comprehend the impact of technical changes in the law, for instance, on investment and loan underwriting decisions.<sup>162</sup> Financial analysts are likely to view these larger issues as a matter of, well, financial analysis, so there may be a tendency to view the Great Credit Contraction as purely another financial development, for example, a shortage of liquidity,<sup>163</sup> leading to an emphasis on monetary policy solutions that impair the value of the dollar without reviving the private mortgage markets.<sup>164</sup>

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159. See Victor Cholewicki, *There's a Huge Price for Violating Mortgage Contracts*, WALL ST. J., Oct. 7, 2008, at A26; Efrati, *supra* note 141; Gottlieb & McGuinness, *supra* note 148; Stephen F.J. Ornstein, Matthew S. Yoon, David A. Tallman, Richard B. Horn & John P. Holahan, *Massachusetts Sues Fremont*, 61 CONSUMER FIN. L.Q. REP. 716 (2007); Damian Paletta, Jessica Holzer & Ruth Simon, *U.S. Steps Up Help for Homeowners*, WALL ST. J., Nov. 12, 2008, at A3 (noting Congressional proposal for a moratorium on foreclosures). See also sources cited *supra* note 109.

160. See Associated Press, *Economists Warn of Slow Pending*, OKLAHOMAN, Sept. 16, 2009, at 3B; Henry Kaufman, *The Real Threat to Fed Independence*, WALL ST. J., Nov. 11, 2009, at A21; Review & Outlook, *The Fannie Mae Dice Roll Continues*, WALL ST. J., Nov. 11, 2009, at A20; sources cited *supra* notes 1–3.

161. Compare the preferred emphasis on solutions dependent on increased regulation and federal expenditures, as cited *supra* notes 118–130. See also sources cited *supra* notes 71, 86.

162. See *supra* notes 149, 150; Harrell, *supra* note 78.

163. See sources cited *supra* notes 114–143. This would explain the emphasis on monetary solutions, and why this hasn't worked. See, e.g., sources cited *supra* notes 1–3.

164. See sources cited *supra* notes 1–3, 114–143; *supra* Part I.B.2; see also George Will, *A Gold Standard on U.S. Debt*, OKLAHOMAN, Nov. 12, 2009, at 10A (noting world-wide concerns with the declining value of the U.S. currency).

*B. Federal Legislation and Proposals*<sup>165</sup>

As suggested above, the Great Credit Contraction began partly as the cyclical consequence of a financial bubble created by volatile FRB monetary policies and federal housing subsidies, but was reinforced by ill-timed crackdowns on subprime lending that cut-off access to credit for many consumers at the worst possible point in the economic cycle. What is wholly different this time is the way that subsequent policy responses make it more likely that the Great Credit Contraction will continue for years to come and will effectively preclude the economy from a normal recovery. These responses have created bottlenecks in the credit system, assuring that federal monetary and fiscal stimulus efforts will be largely ineffective, except possibly (as noted) to create new asset bubbles in stock and commodities prices.<sup>166</sup> A few examples are noted below.

The Mortgage Reform and Anti-Predatory Lending Act of 2007, introduced by Representative Barney Frank and passed by the U.S. House of Representatives on November 15, 2007,<sup>167</sup> and the Home Ownership Preservation and Protection Act of 2007, introduced by Senator Christopher Dodd on December 12, 2007,<sup>168</sup> are prime examples of the damage that can be done by mere proposals. Just as the credit and housing markets were collapsing, these bills sought to further restrict and discourage mortgage lending.<sup>169</sup> The Emergency Home Ownership and Mortgage Equity Protection Act<sup>170</sup> and the Foreclosure Prevention Act of 2008<sup>171</sup> were even worse,<sup>172</sup>

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165. See generally Ornstein et al., *supra* note 140 (describing many of the proposals noted here).

166. See Judy Shelton, *The Fed's Woody Allen Policy*, WALL ST. J., Nov. 12, 2009, at A25; Joanna Slater, William Mallard & Bob Davis, *World Tries to Buck Up Dollar—Thailand, Korea, Russia Seen Buying U.S. Currency; Pressure on China to Boost Yuan*, WALL ST. J., Nov. 12, 2009, at A1; sources cited *supra* notes 23–28, 37, 42, 71, 74, 106, 111.

167. H.R. 3915, 110th Cong. (2007). See generally Caggiano, Franzén & Dozier, *supra* note 144, at 517–524 (discussing federal policy responses to the Great Credit Contraction).

168. S. 2452, 110th Cong. (2007).

169. Caggiano, Franzén & Dozier, *supra* note 144; see also Stephen F.J. Ornstein & Matthew S. Yoon, *Update on Federal Anti-Predatory Lending Legislative Effort*, 61 CONSUMER FIN. L.Q. REP. 620 (2007); Harrell, *supra* note 97, at 630–31.

170. H.R. 3609, 110th Cong. (2007).

171. S. 2636, 110th Cong. (2008).

172. See Ornstein & Yoon, *supra* note 169; see also Caggiano, Franzén & Dozier, sources cited *supra* notes 3, 144.

responding to the foreclosure crisis by proposing to allow debtors to “cram down” home mortgage liens in Chapter 13 bankruptcy cases, unilaterally rewriting the mortgage contract by reducing the mortgage lien to the depressed value of the home.<sup>173</sup> Obviously, this would overturn the traditional legal structure and the economic bargain for mortgage lenders and investors.<sup>174</sup>

Probably not everyone agrees with this assessment, and perhaps some would respond that this is just the way things work in Washington, D.C. But there can be little doubt that the value of homes widely “crashed,” and private credit availability simultaneously dried up in the Great Credit Contraction that accompanied serious consideration of these measures.<sup>175</sup> There is also little doubt that, in a period of dramatic declines in housing prices, many borrowers would like to rewrite their mortgage contracts to reduce their creditors’ mortgage liens and alter other property rights, and that elimination of the “anti-modification” clause in Bankruptcy Code section 1322(b)(2) (which protects home mortgage liens from modification in Chapter 13 cases) is a prime prospect for accomplishing that wish.<sup>176</sup> Indeed, who among us would not like to do this very thing?

But the real question is not whether consumers would like to have, essentially, free money and a one-sided mortgage relationship (for example, if housing prices go up, the borrower wins; if they go down, the creditor loses). The real concern should be the effect that the prospects for such a legal environment has on the cost and availability of private mortgage credit (and housing values). Industry representatives commonly argue that allowing a cram-down of home mortgage liens would significantly increase the cost of mortgage

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173. Ornstein & Yoon, *supra* note 169, at 624; *see also* 11 U.S.C. § 1322(b)(2) (2006) (current Bankruptcy Code provision precluding such modifications).

174. Ornstein & Yoon, *supra* note 169. The proposal also would allow the bankruptcy court to modify other terms of the parties’ contract, such as the payment amount and interest rate. Compare this with the analysis of the United States Supreme Court in *Dewsnup v. Timm*, 502 U.S. 410 (1992), and *Nobelman v. Am. Sav. Bank*, 508 U.S. 324 (1993).

175. *See* WILLIAM D. WARREN & DANIEL J. BUSSEL, *BANKRUPTCY* 569–70 (8th ed. 2009) (describing “The 2007 Home Loan Crisis”); sources cited *supra* notes 1–3.

176. *See* sources cited *supra* note 175.

credit (and possibly down payment requirements as well),<sup>177</sup> as lenders and creditors would discount the value of mortgage liens to reflect the potential for further losses during inevitable housing cycles.<sup>178</sup>

This debate was renewed with vigor in 2007, as the Great Credit Contraction began and prospects were presented for shifting additional enormous losses from consumers to mortgage holders.<sup>179</sup> This very debate, and the likely prospect (given the make-up of Congress and the political environment) that advocates of home mortgage cram-downs could prevail, probably contributed to the housing crisis and Great Credit Contraction by causing lenders, investors and other creditors to withdraw capital from the housing and credit markets, just as a cyclical downturn was already beginning. In effect, these kinds of public policy initiatives helped turn a cyclical downturn into the Great Credit Contraction.

Of course, not everyone agrees with this assessment. Some commentators have analogized this scenario to a previous brief period,<sup>180</sup> when some courts were allowing cram-downs of mortgage liens under various theories (before that was limited by the United States Supreme Court<sup>181</sup>), for example concluding that this “empirical evidence . . . suggests that interest rates did not materially rise during the 15-year period in which [section] 1322(b)(2) was effectively gutted in several circuits by the ‘bifurcation’ theory eventually

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177. See, e.g., WARREN & BUSSEL, *supra* note 175 (estimating an increase of one to one and a half or more in interest rates). Your author considers this to be an overly conservative estimate.

178. *Id.*; see also *Nobelman*, 508 U.S. 324, 332 (Stevens, J., concurring) (noting the importance of protecting home mortgage liens in order to encourage the “flow of capital into the home lending market”).

179. Although nominally such losses are shared by both borrowers and creditors, in reality the financial losses suffered by creditors far exceed those suffered by borrowers. Given the minimal down payment requirements of recent years, see WARREN & BUSSEL, *supra* note 175, almost the entire financial loss comes from the creditor’s investment. As to any deficiency in the debt owed, many states have anti-deficiency statutes that protect borrowers in these circumstances, and in any event many such borrowers are financially judgment-proof and/or can discharge the liability in bankruptcy. This is not to downplay the emotional trauma imposed on homeowners when there is a credit contraction and housing market collapse, but this emotion should not obscure the financial consequences. See, e.g., Byrkit, *supra* note 156, at 278–280.

180. Basically the time between the decisions in *Gaglia v. First Fed. Sav. & Loan Ass’n*, 889 F.2d 1304 (3d Cir. 1989), and *Dewsnup v. Timm*, 502 U.S. 410 (1992).

181. See *Gaglia*, 889 F.2d 1304; *Dewsnup*, 502 U.S. 410; see also *Nobelman*, 508 U.S. 324.

rejected by *Nobelman* in 1993.”<sup>182</sup> In your author’s experience, this window of legal uncertainty was even narrower,<sup>183</sup> and coincided with the previous credit and housing crisis (in the late 1980s and early 1990s), which was much like the current one.<sup>184</sup> This reinforces, rather than disproves, your author’s observations here about the adverse impact of bankruptcy cram-downs on mortgage credit costs and availability. It is not too much to note that the credit and housing boom of 1993–2006 began only after *Dewsnup* and *Nobelman* resolved these issues in a manner consistent with traditional legal principles, rejecting the *Gaglia* analysis allowing such cram-downs, and that the end of the boom coincided with a renewed debate on these issues and the introduction of new cram-down legislation.<sup>185</sup> Obviously, other significant factors were also at work,<sup>186</sup> but it is surely more than coincidence that the promise of judicial and policy initiatives designed to impair mortgage liens and the enforcement of credit contracts has coincided with periods of reduced credit availability and declining housing values. Indeed, the relation is so dramatic, and apparent, that one can only marvel at attempts to ignore or deny it.

Obviously, and as noted above, proposed cram-down legislation is not the only such factor contributing to the Great Credit Contraction.<sup>187</sup> But in conjunction with other efforts—state and federal—to crack down on subprime mortgage lending,<sup>188</sup> and responses to the rise in foreclosures that have included impediments on traditional foreclosure remedies,<sup>189</sup> these policy initiatives have created a new legal environment that calls into question the routine enforceability of mortgage loan contracts and liens. Given that

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182. WARREN & BUSSEL, *supra* note 175, at 566.

183. See sources cited *supra* note 180.

184. See *supra* Parts I.B.2–5.

185. See sources cited *supra* notes 173–184.

186. See *supra* Parts I.B.2–5.

187. See also sources cited *supra* note 3; *supra* Part I.B.

188. For examples, see Richard A. Vance, *Mortgage Lending Variations in the Bluegrass Nation: Kentucky Sweeping Mortgage Lending Bill*, 62 CONSUMER FIN. L.Q. REP. 117 (2008); Ornstein et al., *supra* note 140; sources cited *supra* note 3.

189. See *Commonwealth v. Fremont Inv. & Loan*, 897 N.E.2d 548 (Mass. 2008), noted in WARREN & BUSSEL, *supra* note 175, at 570; and Ornstein et al., *Massachusetts Sues Fremont*, *supra* note 159.



mortgage lending and other types of credit, as creatures of the law, are dependent on confidence in the enforceability of contracts and liens, it is not difficult to recognize that current policy measures are scaring away the private investment and credit needed to support healthy credit markets.<sup>190</sup> This is particularly true for mortgage markets, where the traditionally low interest rates and extended loan terms are viable for private capital only in the absence of significant legal and monetary risk.

Publicly denouncing creditors and impairing creditors' rights and remedies may be popular with the media and some members of the public, but are not helpful in attracting the capital needed for smoothly functioning credit markets. These markets have been essential to western capitalism for centuries. The recent public posturing and mismanagement of credit and financial policies have now called this system into question, in the process shaking confidence in the viability of contracts and property law and even the rule of law itself. This cannot be done without adversely affecting the interests of ordinary citizens and consumers.<sup>191</sup>

This is part of an overall pattern that includes the effective nationalization of mortgage finance through: Fannie and Freddie; an expanding role for the FHA; massive subsidies for large, high profile institutions; the expansion of FDIC insurance liability;<sup>192</sup> pressures on bank management to expand credit;<sup>193</sup> and the arrangements between the U.S. Treasury and the FRB to monetize the public debt and have the FRB expand its balance sheet to maintain funding for mortgage finance.<sup>194</sup> The result is that an entirely new federal system

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190. See sources cited *supra* notes 1–3.

191. See sources cited *supra* notes 1–3, 109, 127.

192. See sources cited *supra* notes 118–119, 143. On the risks of expanding federal deposit insurance, see also Alan S. Blinder & R. Glenn Hubbard, *Blanket Deposit Insurance Is a Bad Idea*, WALL ST. J., Oct. 15, 2008, at A17.

193. See, e.g., Sudeep Reddy, *Bernanke Defends Policy of Low Rates*, WALL ST. J., Aug. 23, 2008, at A3; Review & Outlook, *The Senate's Bankers*, WALL ST. J., Oct. 25 2008, at A12. This is not limited to the Obama administration. The U.S. Treasury Department's 2007 "Blueprint" for financial reform sought to significantly centralize the laws governing payments, insurance, securities transactions, etc. See, e.g., Meghan Stringer Musselman, *U.S. Treasury Department Plan for the Overhaul of Financial Institution Regulation*, 61 CONSUMER FIN. L.Q. REP. 847 (2007).

194. See Review & Outlook, *Secretary of the Fed*, WALL ST. J., Mar. 20, 2009, at A14; Paul, *supra* note 105; sources cited *supra* notes 112–142; Lampe, Miller & Harrell, *supra* note 141, at 470.

of mortgage finance has been created to displace the private funding mechanisms impaired by recent changes in state and federal law: housing sales are promoted by paying first-time buyers to buy a house; the loans are originated by a handful of federally-subsidized banks; the loans are sold to federally-owned and funded GSEs (Fannie and Freddie); and the resulting mortgage-backed securities are purchased by the FRB (to the tune of over \$1 trillion so far).<sup>195</sup> The mortgage credit system has been essentially nationalized, in a period of only about eighteen months, as a substitute for the pre-existing private mortgage markets. The public costs are estimated in the trillions, yet foreclosures continue at record levels.<sup>196</sup>

Obviously these measures create a new consumer dependency on the federal government for mortgage finance,<sup>197</sup> and probably reflect a bias (or at least a lack of understanding) on the part of some policy makers,<sup>198</sup> resulting in simultaneous efforts to restrict private subprime lending and expand taxpayer-funded alternatives.<sup>199</sup> As a consequence, the basic role of the United States mortgage and credit markets (and the national currency) have been put at risk,<sup>200</sup> without providing a solution to the Great Credit Contraction. Through it all, no public figure seems cognizant of the issues and the dangers they pose to all consumers.

## CONCLUSION

The causes and effects of the Great Credit Contraction are undoubtedly complex and subtle, and seem to have escaped the

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195. See sources cited *supra* note 194.

196. WARREN & BUSSEL, *supra* note 175, at 570; see also Constance Mitchell Ford, *Foreclosures Continue to Put a Damper on Home Prices*, WALL ST. J., Nov. 11, 2009, at A6; sources cited *supra* notes 35–37, 103.

197. See sources cited *supra* notes 192–196; see also Bob Davis, Damian Paletta & Rebecca Smith, *Unraveling Reagan: Amid Turmoil, U.S. Turns Away from Decades of Deregulation*, WALL ST. J., July 25, 2008, at A1.

198. See sources cited *supra* notes 192–196; see Raum, *Analysis: Officials Running Out of Solutions*, *supra* note 136; sources cited *supra* note 114.

199. See sources cited *supra* notes 142–166 and accompanying text; see also sources cited *supra* notes 1–3, 35–37, 118–119.

200. See sources cited *supra* note 199; see also Review & Outlook, *A Dollar Warning from Asia*, WALL ST. J., Nov. 17, 2009, at A24 (“This is a dangerous game . . .”).

attention of the domestic media and many policy makers.<sup>201</sup> As a result, the policy responses have been largely ineffective, or even counterproductive, with further costs that appear likely to be damaging in the future, perhaps in unprecedented ways.<sup>202</sup> No matter what these consequences ultimately entail, they are not likely to include the broad public participation in the credit system and housing markets that were features of the traditional American system of private finance that was so readily cast aside.

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201. Though not the world. See Review & Outlook, *supra* note 200.

202. *Id.*; see also sources cited *supra* notes 5, 7, 23, 25, 33, 37, 40–42, 71, 73, 78, 87, 88, 101, 107, 111–121; Steve H. Hanke & David Ransom, *The Fed and the Price of Rice*, WALL ST. J., June 10, 2008, at A17 (noting the correlation between FRB monetary policy and the 2008 commodities bubble); Review & Outlook, *Run on Washington*, WALL ST. J., July 17, 2008, at A14 (predicting a global “run” on the dollar and U.S. economy due to declining confidence in U.S. financial policies); George Melloan, *Inflation and the Bush Legacy*, WALL ST. J., July 17, 2008, at A15 (noting the adverse effects of inflation).