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The Subprime Crisis--A Test Match For the Bankers: Glass-Steagall vs. Gramm-Leach-Bliley

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The Subprime Crisis--A Test Match For the Bankers: Glass-Steagall vs. Gramm-Leach-Bliley

By

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ABSTRACT

This article addresses the ongoing debate over whether the repeal of the Glass-Steagall Act of 1933 by the Gramm-Leach-Bliley Act of 1999 ("GLBA") laid the groundwork for the subprime crisis. The Glass-Steagall Act prohibited commercial banks from engaging in investment banking activities such as underwriting and dealing in equity securities. The GLBA removed that barrier, allowing banks to become financial supermarkets. However, the article concludes that GLBA played little if any role in the events surrounding the subprime crisis.

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I

Introduction

The United States has just experienced one of the worst financial crises in all history. Several investment banks failed or had to be bailed out by the federal government. They included such behemoths as Merrill Lynch, Bear Stearns, Morgan Stanley and Lehman Brothers.[2] Over one hundred commercial banks failed in 2009 as a result of the crisis,[3] and several large commercial banks also had to be rescued or bailed out, including Citigroup, Bank of America and Wachovia Corp.[4] Giant residential mortgage lenders that failed included Washington Mutual, Countrywide Financial and IndyMac. The American International Group., Fannie Mae and Freddie Mac failed, as did General Motors and Chrysler. The economy suffered as well, with unemployment levels reaching nearly ten percent nationwide and even higher in some states. Total job losses exceeded 7.2 million.[5] The problem spread worldwide. In the U.K. the victims of the crisis included the Royal Bank of Scotland, Lloyds TSB and Northern Rock. Banks in Germany and France had to be rescued too. Ireland and Iceland's major banks had to be bailed out or nationalized.[6]

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[2] Michael Lewis & David Einhorn, *The End of the Financial World As We Know It*, N. Y. TIMES, Jan. 4, 2009, at WK9; Louise Story, *Extreme Makeover at Morgan Stanley*, N. Y. TIMES, Nov. 26, 2008, at B1.
[3] Associated Press, *Seven Bank Failures Bring the Total to 106 for the Year*, N. Y. TIMES, Oct. 24, 2009, at B4.
[4] *See* Eric Dash, *Seeking A Roadway To Solvency*, N. Y. TIMES, Nov. 25, 2008, at B1.
[5] *Rise in New Jobless Claims Was Higher Than Expected*, N. Y. TIMES , Oct. 23, 2009, at B8.
[6] For a description of the failures occurring during the subprime crisis see DAVID WESSEL, IN FED WE TRUST *passim* (2009).

This debacle touched off a debate on whether the removal in 1999 (by the Graham-Leach-Bliley Act ("GLBA")[7]) of the dividing line between commercial and investment banking activities (dictated by the Glass-Steagall Act of 1933)[8] laid the groundwork for the subprime crisis.[9] This article will address that debate. It first traces the background for the adoption of the Glass-Steagall Act and describes the successful efforts to undermine its proscriptions through the use of so-called "Section 20" subsidiaries and other devices. The article also describes the events that led to the passage of the GLBA and addresses whether it laid the groundwork for the subprime crisis. The article concludes that it did not.

II

Some Banking History

Background

Banking in the United States has a colorful, but confusing, history that is laced with populist resentments and fears of concentrated wealth in banks and other commercial enterprises, concerns that are commonly associated with Thomas Jefferson and Andrew Jackson. Opposing those populists were Alexander Hamilton and his supporters who viewed banks and other aspects of big business to be a necessary part of building and maintaining a national, now international, economy. This debate over the role of banks in society has been, at least before the subprime crisis, purely an American one.

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[7] Financial Services Modernization Act, Pub. L. 106-102, 113 Stat.1338 (1999)(codified at scattered sections of 12 U.S.C. and 15 U.S.C.).
[8] The Banking Act of 1933, ch. 89, 48 Stat. 162 (codified as amended at scattered sections of 12 U.S.C. (1988)).
[9] *See e.g.*, LAWRENCE G. MCDONALD & PATRICK ROBINSON, A COLOSSAL FAILURE OF COMMON SENSE: THE INSIDE STORY OF THE COLLAPSE OF LEHMAN BROTHERS 7 (2009).

The American experience is colored by the fact that during the colonial period the Crown effectively prohibited banking in the colonies.[10] This left the nation to develop its own banking system after the Revolution. Alexander Hamilton, as Secretary of the Treasury, laid the groundwork for that effort through a proposal in 1790 for the creation of a "Bank of the United States" ("BUS"), which would perform the functions of a central bank. Hamilton's proposal for a central bank was modeled after the Bank of England and, to some extent, the central banks on the continent.[11] His recommendation proved to be quite controversial. Some cabinet members, including Edmund Randolph, the attorney general, and Thomas Jefferson, the Secretary of State (who believed that "banking establishments are more dangerous to our liberties than standing armies")[12], opposed Hamilton's proposal, as did James Madison. However, President Washington threw his support behind Hamilton and refused to veto the legislation that created the BUS. This schism laid the groundwork for the division along party lines of the federal government that exists today.[13]

Even Hamilton believed that the BUS should be a creature with limited powers. He believed that it should be fenced off from commercial and speculative operations. The bank's charter, therefore, prohibited the BUS from investing in land or buildings and from dealing in goods, wares, merchandise or commodities. Provision was made for bounties to be paid to anyone reporting violations of those proscriptions.[14] Despite those limitations, the BUS became a

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[10] *See* Christian C. Day, *Dispersed Capital and Moral Authority: The Paradox of Success in the Unregulated 19th Century New York Capital Markets*, 12 L. & BUS. REV. AM. 303, 304 (2006).
[11] *See* RON CHERNOW, ALEXANDER HAMILTON 344-354 (2004).
[12] *See* WILLIAM F. HIXSON, TRIUMPH OF THE BANKERS: MONEY AND BANKING IN THE 18TH AND 19TH CENTURIES 94 (1993).
[13] For an account of this debate in the Washington cabinet see Willard Sterne Randall, THOMAS JEFFERSON, A LIFE 505 -507 (1993).
[14] *See* JERRY W. MARKHAM, 1 A FINANCIAL HISTORY OF THE UNITED STATES, FROM CHRISTOPHER COLUMBUS TO THE ROBBER BARONS (1492-1900) 89 (2002) [hereinafter MARKHAM, VOL. I].

commercial success with five branches operating around the country. It was also a valuable asset for the federal government, allowing the executive branch to borrow $6 million by 1796.[15]

The BUS became a victim of its own success. Competing private banks resented BUS and were able to prevent its charter renewal by the Congress in 1811.[16] The liquidation of BUS as a national bank left the country adrift financially, leading to a financial crisis during the war of 1812. Awakening to its value, Congress chartered a new BUS in 1816. The second BUS became a source of financial stability and was even able to exercise some supervisory control over private banks that were often irresponsible in their operations.[17]

Despite its usefulness, populous politicians, who thought the BUS had aggregated too much power unto itself, hated the second BUS. Its chief critic was General Andrew Jackson, the hero of New Orleans, who vowed its destruction during his presidential campaign. True to his word, after becoming president Jackson destroyed the second BUS following an epic political struggle with Henry Clay, who had made that fight the centerpiece for his own campaign for President. Jackson prevailed, but the country was left without a central bank until 1913.[18]

Following the demise of the second BUS, banks became solely creatures of the states, and were regulated only loosely by those governments.[19] However, the Civil War led to the creation of national bank charters and a "dual" banking system, in which banks could choose to be regulated by their own state regulators, by adopting a state charter, or they could elect to be a

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[15] *Id*. at 90.

[16] *See* Arthur E. Wilmarth, Jr., *The Expansion of State Bank Powers, The Federal Response, and the Case for Preserving the Dual Banking System*, 58 FORDHAM L. REV. 1133, 1153 (1990).

[17] *See* Susan Pace Hamill, *From Special Privileges to General Utility: A Continuation of Willard Hurst's Study of Corporations*, 49 AM. U. L. REV. 81, 99 (1999).

[18] For a description of the battle between Jackson and Clay over the bank see ARTHUR M. SCHLESINGER, JR., THE AGE OF JACKSON 74-131 (1945). For a description of the battle between Jackson and Clay over the bank see Arthur M. Schlesinger, Jr., *The Age of Jackson* 74-131 (1945).

[19] In 1846, further legislation was passed that removed all federal funds from private state banks and deposited them in Treasury Department offices. This completely separated the federal government from the private money markets. Raichle v. Federal Reserve Bank of New York, 34 F.2d 910 (2d Cir. 1929).

national bank regulated by the Office of the Comptroller of the Currency ("OCC") in the Treasury Department.[20] Unlike national banks, state banks were prohibited from issuing their own notes that could act, as had previously been the case, as a circulating currency. This did not deter the state banks, because their depository facilities and checking operations were still a valuable service for customers.[21]

Banking Powers

The state banks had been leaders in investment banking and were free to engage in underwriting and dealing activities in stocks.[22] National banks, however, were restricted in their investment and operations to matters specified in the National Bank Act of 1864,[23] plus any "incidental" powers needed to carry out that business.[24] Section 28 of that legislation restricted, for example, national banks in real estate holdings to properties used to transact its own business and to real estate mortgages only as security or payment for "previously contracted" debts.[25] Dealing in stocks by national banks was "not expressly prohibited; but such a prohibition is implied from the failure to grant the power."[26] National banks were allowed to broker securities for customers,[27] but the OCC ruled in 1902 that national banks did not have the power to act as

[20] Judge Augustus N. Hand described the creation of the national banking system as follows:

> To meet the necessities of Civil War, national banks were established. They became the official depositaries of the government and furnished an enlarged currency, because of their ability to issue circulating notes against government bonds deposited with the Treasurer of the United States. They were required to maintain reserves in certain cities, based upon a percentage of their deposits.

Raichle v. Federal Reserve Bank of New York, 34 F.2d 910 (2d Cir. 1929).

[21] BRAY HAMMOND, SOVEREIGNTY AND AN EMPTY PURSE: BANKS AND POLITICS IN THE CIVIL WAR 335 (1970).

[22] George G. Kaufman and Larry R. Mote, *Glass-Steagall: Repeal by Regulatory and Judicial Reinterpretation*, 107 BANKING L. J. 388, 391-392 (1993).

[23] National Bank Act of 1864, 13 Stat. 99 (1864) (current version codified as amended at 12 U.S.C. §21 et seq.) (2006).

[24] First Nat'l Bank of Charlotte v. Nat'l Exch. Bank of Baltimore, 92 U.S. (2 Otto.) 122 (1875).

[25] National Bank Act of 1864, ch. 106, §28, 13 Stat. 99, 107-108 (1864)

[26] Bank of Charlotte, 92 U.S. at 122 (1875).

[27] Block v. Pa. Exch. Bank, 170 N.E. 900 (Ct. App. N.Y. 1930).

an underwriter of stocks.[28] As will be seen, the Comptroller's ruling laid the foundation for the prohibitions in the Glass-Steagall Act that divided commercial and investment banking activities.[29] Before the passage of that legislation, however, several large national banks used a bit of legal legerdemain to evade the Comptroller's ruling.

The banks concluded they could do indirectly that which they could not do directly by creating affiliates that would do the underwriting. Leading that effort was the National City Co. an affiliate of the National City Bank, which was controlled by the Rockefellers and the J.P. Morgan investment banking firm and which, ironically, eventually became Citigroup Inc.[30] The National City Co. was funded with a forty percent dividend on its $25 million in stock that was assigned to three bank officers acting as trustees with the sole power to vote the National City

[28] David M. Eaton, *The Commercial Banking-Related Activities of Investment Banks and Other Nonbanks*, 44 EMORY L.J. 1187, 1192 n. 20 (1995). This separation of investment and commercial banking activities seemed to be based on the English model that:

> made a sharp division between the types of institutions participating in the commercial banking and investment banking functions. Recognized banking authorities there considered investment banking an inherently risky and speculative venture and, for that reason, considered any dealings in stocks and bonds an improper business pursuit for financial institutions entrusted with the savings of the general public. To a greater extent than we are apt to realize, what in the United States is generally meant by conservative, or sound, banking practice is simply the tacit acceptance of English standards.

Edwin J. Perkins, *The Divorce of Commercial and Investment Banking: A History*, 88 BANKING L.J. 484, 485 (1971). The English abandoned that approach in the "Big Bang" regulatory reforms that were ushered into the London markets in 1986. Danny Fortson, The Day Big Bang Blasted the Old Boys Into Oblivion, THE INDEPENDENT, Oct. 29, 2006.

[29] One author describes the dividing line between commercial and investment banks at the end of the eighteenth century as follows:

> Prior to 1900, commercial and investment banking were generally conducted by wholly separate entities. Although no explicit law prohibited the intermingling of deposit/loan banks with securities underwriting, judicial decisions effectively proscribed it. (No such limitations applied to solely state-chartered institutions.) Pursuant to case law, the Comptroller of the Currency issued administrative edicts proclaiming the impermissibility of crossover. After the turn of the century, however, increased demand for capital spurred the Comptroller to let commercial national banks underwrite corporate and municipal debt, though equity issues remained the domain of the investment banking houses.

David M. Eaton, *The Commercial Banking-Related Activities of Investment Banks and Other Nonbanks*, 44 EMORY L.J. 1187, 1192 (1995) (footnotes omitted).

[30] [30] *See* JERRY W. MARKHAM, II A FINANCIAL HISTORY OF THE UNITED STATES, FROM J.P. MORGAN TO THE INSTITUTIONAL INVESTORS (1900-1970) 23 (2002) [hereinafter MARKHAM, VOL. II].

stock. Unlike the bank, the National City Co. had no limitations on its powers and could engage in any lawful business.[31]

In 1911, the U.S. Solicitor General, Fredrick W. Lehman, considered whether the National City Bank's affiliation with the National City Co. violated banking laws. Lehman noted that the National City Co. had invested in the shares of sixteen banks and trust companies, as well as other businesses. Lehman asserted that these investments raised the specter of National City gaining control over large banks nationwide:

> The temptation to the speculative use of the funds of the banks at opportune times will prove to be irresistible. Examples are recent and significant of the peril to a bank incident to the dual and diverse interests of its officers and directors. If many enterprises and many banks are bought and bound together in the nexus of a great holding corporation, the failure of one may involve all in a common disaster. And, if the plan should prosper, it would mean a union of power in the same hands over industry, commerce and finance, with a resulting power over public affairs, which was the gravamen of objections to the United States Bank.[32]

Lehman concluded that the National City Company's holding of the stocks of other national banks was "in usurpation of federal authority and in violation of federal laws."[33] However, Franklin MacVeagh, the Secretary of the Treasury, a former long time director of the Commercial National Bank of Chicago, disagreed with that claim. The matter was then submitted to President William H. Taft, who was convinced by Franklin A. Vanderlip, president of the National City Bank, and Henry P. Davidson, a partner at J.P. Morgan, at a secret White House meeting in 1911, to suppress the Solicitor General's opinion.[34] "The original copy of the Lehman opinion had disappeared from the files of the Justice Department sometime prior to

[31] *See* JOHN K. WINKLER, THE FIRST BILLON: THE STILLMANS AND THE NATIONAL CITY BANK 202-203 (1934).
[32] *Id*. at 206.
[33] *Id*.
[34] *See* FERDINAND LUNDERG, AMERICA'S 60 FAMILIES 102 (1937).

1913, so that only a carbon copy remained."[35] However, The Senate Banking and Currency Committee discovered Lehman's opinion during the inquiry into the Stock Market Crash of 1929. In May 1932, Senator Carter Glass dramatically revealed its existence in a floor speech in the Senate in May 1932, laying the groundwork for the passage of the Glass-Steagall Act in the following year.[36]

The Fed

The nation experienced one of its most serious economic crises during the Panic of 1907, an event that was marked by a privately mounted effort to rescue faltering financial institutions. During that panic, J.P. Morgan famously locked a group of bankers in his library until they could reach agreement on a rescue package.[37] In response to that crisis, Congress passed the Aldrich-Vreeland Currency Act in 1908, which created the National Monetary Commission for the purpose of studying and proposing changes to the banking structure that would prevent another such panic. Senator Nelson Aldrich was appointed as its head, but private bankers largely controlled the lengthy and detailed studies conducted by the Commission.[38]

Disguised as duck hunters, a group of those bankers met on Jekyll Island in Georgia in 1910 and came up with a plan for a central banking system controlled by private banks.[39] Democrats blocked that proposal, but Congressman Carter Glass from Virginia, and the future co-sponsor of the Glass-Steagall Act, brokered a compromise on behalf of the Woodrow Wilson

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[35] Edwin J. Perkins, *The Divorce of Commercial and Investment Banking: A History*, 88 BANKING L.J. 483, 517 (1971).
[36] *Id*.
[37] *See* ROBERT F. BRUNER & SEAN D. CARR,THE PANIC OF 1907 (2007) (description of the 1907 panic). For a description of Morgan's role in this rescue see JEAN STROUSE, MORGAN AMERICAN FINANCIER 573-596 (1999).
[38] 38 *See* RON CHERNOW, THE HOUSE OF MORGAN 129-130 (1990).
[39] *See* G. EDWARD GRIFFIN, THE CREATURE FROM JEKYLL ISLAND (1994).

administration.[40] That compromise adopted the concept of regional Federal Reserve banks that would be owned and controlled by private member banks, but Wilson and Glass insisted on an oversight board controlled and appointed by the government in Washington (the Federal Reserve Board).[41] With that compromise, the Federal Reserve Act was passed in 1913.[42]

The Pujo Committee

An investigation by the House Committee on Banking and Currency that began in 1912 and was headed by Arsene Pujo from Louisiana, looked for, and found, a "money trust" composed of an interlocking web of directorships among banks and large industrial enterprises.[43] The Pujo Committee also renewed concerns with the securities affiliates created by the large banks like the National City Co. The Committee believed that the affiliates were being used to evade regulatory restrictions on bank securities activities, which of course they were.[44] Nothing came of that criticism, however, at least until the passage of the Glass-Steagall Act.

The Stock Market Crash of 1929

The securities affiliates of the large banks provided a mechanism for them to participate in the stock market run up that occurred at the end of the 1920s. The National City Co. and the securities affiliate of Chase National Bank (now JPMorgan Chase), as well as other such affiliates were underwriting securities offerings and operating retail brokerage operations. Those bank affiliates were handling about one half of all securities underwritings before the 1929

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[40] Carter Glass cut a wide swath in banking history. He was a newspaper publisher in Virginia before being elected to the House of Representatives in 1902 where he served as head of the Banking Committee from 1914-1918. From 1918 to 1920, Glass served as the Secretary of the Treasury. He was elected to the Senate in 1920 and served there for the next twenty-six years. *See* ALLAN H. MELTZER, 1 A HISTORY OF THE FEDERAL RESERVE (1913-1951) 67, n. 4 (1989).
[41] *See* RON CHERNOW, THE HOUSE OF MORGAN 129-130 (1990).
[42] Federal Reserve Act, Pub. L. No. 63-43, 38 Stat. 251 (1913).
[43] *See* H.R. Rep. No. 1593, 62nd Cong. 3d Sess. (1913).
[44] *Id.*.

crash.[45] The National City Co. had offices in fifty-eight cities and employed a private wire system 11,000 miles in length. The National City Co. underwrote over twenty percent of all the bond offerings in the United States during the 1920s; it was a significant underwriter for municipal and state governments; and it acted as underwriter in over 150 foreign bond issues between 1921 and 1929. In total, National City Co. underwrote stock valued at $6 billion in the five-year period preceding the stock market crash.[46]

The National City Co. was headed by Charles Mitchell, who became infamous for his encouragement of national securities selling campaigns that utilized high-pressure sales tactics to induce purchases from often unsophisticated investors. As one author noted, Mitchell "was nicknamed 'Sunshine Charlie' for his infectious optimism. He was the carnival salesman of American Banking, who had transformed his firm into a giant machine for selling stocks."[47] Some of the stock and bond sales by the National City Co. turned out to be disastrous for investors. Of particular note was a series of government of Peru bonds totaling $90 million. National City Co. made no effort to determine if Peru would be able to service the bonds, and the bonds soon went into default. Investors were sold the bonds at $90, but they were trading at less than $5 after the Stock Market Crash of 1929.[48]

Charles Mitchell raised more concerns after he was elevated to head the National City Bank. Mitchell then began a program of promoting the bank's stock through the National City Co., and he engaged in speculative trading in the National City Bank's own stock, driving it up

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[45] *See* Donald C. Langevoort, *Statutory Obsolescence and the Judicial Process: The Revisionist Role of the Courts in Federal Banking Regulation*, 85 MICH. L. REV. 672, 692 (1987).
[46] *See* MARKHAM, VOL. II, *supra* note __, at 116.
[47] LIAQUAT AHAMED, LORDS OF FINANCE, THE BANKERS WHO BROKE THE WORLD 312 (2009).
[48] *See* Jerry Duggan, *Regulation FD: SEC Tells Corporate Insiders to "Chill Out,"* 7 WASH. U. J.L. & POL'Y 159, 165 n. 24 (2001) (citation omitted).

from $20 to $580 per share.[49] By reason of his role as president of the National City Bank, Mitchell was also serving as a director of the Federal Reserve Bank of New York in 1929. Nevertheless, Mitchell defied the Federal Reserve Board's effort to cool the stock market by raising interest rates in the "call" money market that financed speculative margin trading. Mitchell announced in response to Fed's effort to cool speculation that the National City Bank would inject $25 million into the call market and make increasing amounts of funds available in that market as interest rates were raised in order to assure its continuing liquidity.[50]

The activities of the National City Bank and Charles Mitchell caught the eye of Senator Carter Glass. As Professor Donald Langervoort has observed:

> Glass was extremely troubled during the later 1920s by extensive bank lending to finance securities purchases, not because he was opposed to the stock market itself, but because he believed that such lending was taking money away from local businesses in need of credit. He sought to use his influence to pressure the Federal Reserve and the bankers to adopt policies of restraint on brokers' call loans and margin lending, but he was not successful. Research under his direction a few years later uncovered perhaps the most significant statistic leading to eventual passage of the legislation -- by 1930, *some forty-one percent of all commercial bank assets* were invested in securities or securities-related loans. It was during this period that Glass formed a negative view of bank securities affiliates, which he considered a major source of the temptation to divert bank funds away from commercial uses. Indeed, he took personal offense at the deliberate and pointed failure of the officers of the largest banks with such affiliates (particularly Charles Mitchell of National City Bank) to adopt a program of voluntary restraint with respect to brokers' call loans.[51]

The horrors of the Great Depression need not be recounted here, but suffice it to say that the nation was broken economically, and the banking system was wrecked.[52] Over 1300 banks

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[49] *See* MARKHAM, VOL. II,, *supra* note __, at117.
[50] [50] *See* AHAMED, *supra* note __, at 323. In fairness to Mitchell, the Federal Reserve System was in a state of disarray because of policy differences between the Federal Reserve Board in Washington and the New York Federal Reserve Bank. In addition, a small cabal of individuals guided policy at central banks in the U.S. (Benjamin Strong), England (Montagu Norman) France (Emile Moreau) and Germany (Hjalmar Schacht), but they were often at cross-purposes and, if anything, worsened the crisis that arose in the 1930s. *Id. passim*.
[51] Langevoort, *supra* note __, at 694 (footnotes omitted).
[52] *See* T.H. WATKINS, THE GREAT DEPRESSION (1993) (describing those hardships). As another author described the worldwide effects of the Great Depression:

failed in 1930. Another 2,000 banks failed in 1931. By 1932, twenty-five percent of all banks in the United States had failed.[53] The Federal Reserve Board played no meaningful role preventing the Great Depression and did much to prolong it.[54] "Ironically, the very existence of the Federal Reserve System seemed to relieve the big private banks like the House of Morgan from playing the liquefying role they had assumed in earlier panics, such as 1907."[55]

The Glass-Steagall Act

The banking panic was still underway when Franklin D. Roosevelt assumed office. He declared a bank holiday immediately after being inaugurated, closing the banks until they could be examined for solvency. In order to restore confidence in the banking system, his administration created the Federal Deposit Insurance Corp. ("FDIC"), which insured bank deposits from the risk of insolvency.[56] This created a moral hazard that would be realized in future years, but it did restore faith in the banking system and many banks were able to reopen.

Congress was also concerned with the mortgage lending activities of national banks. The McFadden Act that was passed in 1927 had allowed national banks to make residential mortgage

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> real GDP in the major economies fell by over 25 percent, a quarter of the adult male population was thrown out of work, commodity prices fell in half, consumer prices declined by 30 percent, wages were cut by a third. Bank credit in the United States shrank by 40 percent and in many countries the whole banking system collapsed. Almost every major sovereign debtor among developing countries and in Central and Eastern Europe defaulted, including Germany, the third largest economy in the world.

AHAMED, *supra* note __, at 497.

[53] *See* MARKHAM, VOL. II, *supra* note __, at 161.

[54] As noted by Ben Bernanke before he became Fed chairman: "The monetary policy of the 30's led to a deflation which created, among other things, the greatly increased value of debts, which therefore led to more defaults and bankruptcies." WESSEL, *supra* note __, at 42.

[55] DAVID M. KENNEDY, FREEDOM FROM FEAR: THE AMERICAN PEOPLE IN DEPRESSION AND WAR (1929-1945) 69 (1999).

[56] That insurance initially covered amounts up to $2,500 and was increased to $5,000 in 1935. *See* Nicholas Economides, R. Glenn Hubbard, & Darius Palia, *The Political Economy of Branching Restrictions and Deposit Insurance: A Model of Monopolistic Competition Among Small and Large Banks*, 39 J.L. & ECON. 667, 698 (1996). FDIC insurance was increased from $100,000 per depositor to $250,000 during the subprime crisis in 2008. *See* David M. Herszenhorn, *Senate Approves Measure to Reduce Home Foreclosures*, N.Y. TIMES, May 7, 2009, at A4.

loans. The national banks then expanded their mortgage activity "dramatically."[57] That activity raised concerns in Congress that "'an immense overexpansion of real-estate values [had been] set in motion" and that many banks were "hopelessly embarrassed by their real-estate commitments and by the fact that rents and selling values [had] so seriously shrunk."[58] To address those concerns a provision was included in the Banking Act of 1933 that required the Federal Reserve banks to ascertain whether banks were unduly using depositor's funds in "'speculative carrying of or trading in . . . real estate.'"[59] That power did nothing to prevent the subprime crisis.

III

The Rise and Fall Of Glass Steagall

Why Glass-Steagall?

The Glass-Steagall Act of 1933[60] also sought the "complete divorcement" of commercial and investment banking[61] by prohibiting commercial banks from engaging in the "issue, flotation, underwriting, public sale or distribution either wholesale, or retail or through a syndicate participation, of stocks, bonds, debentures, notes or other securities."[62] It is unclear from its legislative history why Congress mandated this divorce.[63] As one court noted, "[w]hen called upon to interpret the Glass-Steagall Act, judges 'face a virtually insurmountable burden due to the vast dichotomy between the ostensible legislative intent and the actual motivations of Congress.' Divining the aim of Congress . . . is particularly formidable because the issue of the

[57] WILLIAM E. LEUCHTENBURG, FRANK ROOSEVELT AND THE NEW DEAL 39 (1965).
[58] *Id*.
[59] *Id*.
[60] Banking Act of 1933, ch. 89, 48 Stat. 162 (codified as amended at scattered sections of 12 U.S.C.).
[61] *See* S. Rep. No.1455, 73rd Cong., 2d Sess., at 185 (1934) (Conf. Rep.).
[62] *See* TWENTIETH CENTURY FUND, INC., THE SECURITY MARKETS 84 (1935).
[63] JIM POWELL, FDR'S FOLLY: HOW ROOSEVELT AND HIS NEW DEAL PROLONGED THE GREAT Depression 57-64 (2003).

proper relationship between commercial banks and their affiliates caused considerable disagreement among legislators and experts who participated in the development of what became the Banking Act of 1933."[64]

There is little factual basis for concluding that the securities affiliates were a particular danger to banks. A study of nearly three thousand banks that failed between 1865 and 1936 concluded that securities activities were not even in the top seven reasons for their failure.[65] A Fed official also testified during the Glass-Steagall hearings that, while there had been abuses with the bank affiliates, the Board did not advocate prohibiting banks from having securities affiliates.[66] Claims were also made that the securities underwritten by bank affiliates were of poor quality, but studies have shown that their underwritings were actually of higher quality than those of the investment banks.[67] The Glass-Steagall Act's "legislative history reflects the notion that the underlying cause of the stock market crash in 1929 and subsequent bank solvencies came about from the excessive use of bank credit to speculate in the stock market."[68] However, that was an issue to be addressed at the bank level, rather the securities affiliates. To remedy that

[64] Securities Ind. Ass'n v. Bd of Gov. of the Fed. Res. Sys., 839 F.2d 47, 56 (2d Cir. 1988)), *cert. denied*, 486 U.S. 1059 (1988). A comment published in the *Harvard Law Review* in 1934 asserted that the Glass-Steagall Act sought "to achieve integrity of the system within itself by forcing bankers to withdraw from conflicting affiliations and by assuring them of a fair return, conservatively earned, in their own field." Legislation, The Glass-Steagall Banking Act of 1933, 47 Harv. L. REV. 325, 326 (1933-1934). For a discussion of the perceived policy grounds behind the Glass-Steagall Act see *e.g*., Edmond M. Ianni, *"Security" Under the Glass-Steagall Act ad the Federal Securities Acts of 1933 and 1934: The Direction of the Supreme Court's Analysis*, 100 BANKING L. J. 100, 103-105 (1983); Note, A Conduct-Oriented Approach to the Glass-Steagall Act, 91 YALE L.J. 102, 103-106 (1981); Note, *Bankers Trust II: Underwriting, Commercial paper Placemen, and the Risk of Loss Under the Glass-Steagall Act*, 76 KY. L.J. 497, 504-507 (1987-1988); Note, *Commercial Bank Private Placement Activity: Cracking Glass-Steagall*, 27 CATH. U. L. Rev. 743, 747-750 (1977-1978); Casey K. McGarvey, *Federal Regulation of Bank Securities Activities: Will Congress Allow Glass-Steagall to be Shattered?* 12 J. CONTEMP. L. 99, 101-105 (1986); Roberta Karmel, *Glass-Steagall: Some Critical Reflections*, 97 BANKING L. J. 631 (1980); Lawrence F. Orbe III, *Glass-Steagall: Lest We Forget*, 11 FL. STATE L. REV. 163 (1983-1984).

[65] *See* MARKHAM, VOL. II, *supra* note __, at 168.

[66] *Id*.

[67] *See* Randall S. Kroszner & Raghuram G. Rajan, Is *the Glass-Steagall Act Justified? A Study of the U.S. Experience With Universal Banking Before 1933*, 84 AM. ECON. REV. 810 (1994).

[68] *Id*.

perceived problem, the Securities Exchange Act of 1934 gave the Federal Reserve Board the power to control bank lending on margin for stocks.[69]

Some think that the Glass-Steagall Act prohibition on stock underwritings was prompted by the failure of the Bank of United States (a New York bank) and its security affiliate, the City Financial Corporation. Bernard K. Marcus and Saul Singer, the two most senior officials at the bank, were indicted and convicted of fraudulent banking practices. The securities affiliate, however, was not shown to have caused the bank's failure. Rather, the bank's worst losses were due to exposures to New York City real estate properties, which plunged in value as the Great Depression began (half of the bank's loan portfolio was devoted to real estate finance).[70] Bank of United States also eventually returned 83.3 cents on each depositor's dollar during its liquidation, not a bad result during the world's greatest depression.[71]

The actual reason for the Glass-Steagall Act proscriptions on investment banking appears to be the concern on the part the act's principal sponsor, Senator Glass, that the Federal Reserve Board had created a speculative "investment banking system."[72] Glass had played a key role in the legislation that created the Federal Reserve in 1913, and he long feared that banks that were members of the Fed would use their borrowings from the Fed for "stock market speculative operations," if they could also act as investment bankers.[73]

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[69] *See* 15 U.S.C. § 78(g) (2006). The Fed has adopted various regulations limiting credit extensions on stocks. For example, banks are limited under Regulation T to loans of fifty percent of stock value. For the history and background of this legislation, see, Jerry W. Markham, *Federal Regulation of Margin in the Commodity Futures Industry -- History and Theory*, 64 TEMPLE L. REV. 59, 101-105 (1991).

[70] *See* AHAMED, *supra* note __, at 386.

[71] *See* JAMES GRANT, MONEY OF THE MIND, BORROWING AND LENDING IN AMERICA FROM THE CIVIL WAR TO MICHAEL MILKEN 203-210 (1992) (describing this failure).

[72] *See* R. Nicholas Rodelli, *The New Operating Standards for Section 20 Subsidiaries: The Federal Reserve Board's Prudent March Toward Financial Services Modernization*, 2 N.C. BANKING INST. 311, 313 n. 17 (1998).

[73] Securities Indus. Ass'n v. Bd. of Gov. of the Fed. Reserve System, 839 F.2d 47 (2d Cir.), *cert. denied*, 486 U.S. 1059 (1988). A biography of Senator Glass that was published in 1939 fails to provide any elucidation on this issue. *See* RIXEY SMITH & NORMAN BEASLEY, CARTER GLASS: A BIOGRAPHY (1939). Glass was a long-time critic of

Relevant to concerns over bank activities during the subprime crisis, Senator Glass asserted that:

> I am objecting to affiliates altogether. I am objecting to a national banking institution setting up a back-door arrangement by which it may engage in a business which the national bank act denies it the privilege of doing. If investment banking is a profitable business, who does not know that such business will be set up as a separate institution, not using the money and prestige and facilities of a national bank and its deposits to engage in investment activities? *I want to make it impossible hereafter to have the portfolios of commercial banks filled with useless speculative securities, so that when stringency comes upon the country these banks may not respond to the requirements of commerce.* That is what is the matter with the country to-day, and it is because this bill would avert a repetition of that disaster that intense and bitter opposition has been organized against it.[74]

However, "Senator Glass' aspiration to divorce completely commercial banks from their security affiliates was not attained . . . ."[75] because the statute as enacted contained a number of exceptions for bank affiliate securities activities. The banks would exploit those loopholes in the coming decades in order to compete with the securities industry. This touched off a long running war with the securities industry, which, as one prominent scholar concluded, used the Glass-Steagall Act as a barrier to protect its investment bankers from competition from commercial banks.[76] In the event, the Glass-Steagall Act ultimately proved a disappointment to everyone, including Carter Glass who sought a repeal of its provisions a year after its enactment.[77]

The Glass-Steagall Act sought to create a less complicated banking system than the universal bank model employed in Europe, a simplification that was aided by the Fed's

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speculation on the New York Stock Exchange, but was conflicted on the issue of whether increased interest rates should be used to curb speculation. He knew that increased rates also caused a drop in the value of bonds, hurting bondholders, including those holding government bonds. Glass did believe strongly that the facilities of the Fed should not be made available for loans to speculators, who had appeared after World War I in large numbers. *Id*. at 182-184.

[74] 76 CONG. REC. 2000 (1933) (emphasis supplied).

[75] *Sec. Indus. Ass'n*, 839 F.2d at 59.

[76] *See* Jonathan Macy, *Special Interest Groups Legislation and the Judicial Function: The Dilemma of Glass-Steagall*, 33 EMORY L.J. 1 (1984).

[77] *See* LISSA L. BROOME & JERRY W. MARKHAM, REGULATION OF BANKING FINANCIAL SERVICE ACTIVITIES, CASES AND MATERIALS, 722 (3d ed. 2008) [hereinafter BROOME & MARKHAM, REGULATION OF BANKING].

regulation of interest rates through Regulation Q. Under this regime, bankers benefited from the so-called "3-6-3" rule — banks borrowed money at the Regulation Q interest rate of 3 percent; loaned money at 6 percent; and (having nothing else to do) played golf at three o'clock.[78] In the 1960s, however, inflation began squeezing the banks ability to profit, and they began expanding and crossing regulatory boundaries in order to staunch the bleeding. Rather than opposing such attempts, Comptroller of the Currency James J. Saxon actually encouraged it, taking an expansive view of the banking laws.[79] "Saxon substantially changed the agency by expanding its legal and economic staffs, undertaking a program to expand bank powers, and welcoming new banks and branches into the national banking system in contrast to the more restrictive practices of his immediate predecessors."[80] Saxon's rulings allowing banks to intrude into other areas of commerce were occasionally subjected to legal challenges, and some of his rulings were struck down by the courts.[81] Nevertheless, his successors in the OCC continued to interpret banking laws in ways that allowed banks to expand into areas that competed with other financial services firms.[82]

The securities industry, which the investment bankers dominated, challenged a number of the expanded commercial bank activities authorized by the OCC.[83] In 1971, for example, the

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[78] Banks sometimes avoided Regulation Q ceilings by offering advertising premiums for new business and by offering toasters and other giveaways to attract depositors. *See* HERBERT V. PROCHNOW & HERBERT V. PROCHNOW, JR., THE CHANGING WORLD OF BANKING 60 (1974).

[79] Jerry W. Markham, *Banking Regulation: Its History and Future*, 4 N.C. BANKING INST. 221, 240 (2000) [hereinafter *Banking Regulation*].

[80] http://www.occ.treas.gov/saxon.htm.

[81] *See*, *e.g.*, Saxon v. Ga. Ass'n of Indep. Ins. Agents, 399 F.2d 1010 (5th Cir. 1968) (overturning the Comptroller's 1962 ruling that national banks could properly act as insurance agents); *see also* Arnold Tours, Inc. v. Camp, 400 U.S. 45 (1970) (overturning the Comptroller's ruling that national banks could properly provide travel services to customers because such services were incidental to the business of banking).

[82] George G. Kaufman and Larry R. Mote, Glass-Steagall: Repeal by Regulatory and Judicial Reinterpretation, 107 Banking L.J. 388 (1993).

[83] *See generally* Securities Industry Ass'n, *Public Policy Issues Raised by Bank Securities Activities*, 20 SAN DIEGO L. REV. 339 (1982-1983) (securities industry views on bank securities activities).

Supreme Court held in *Investment Company Institute v. Camp*,[84] that the operation by commercial banks of a commingled investment account violated the Glass-Steagall Act because it operated like a mutual fund. The Supreme Court rolled out a litany of horrors, which it termed "subtle hazards," that could arise if banks were allowed to engage in such activity.[85] Banks did subsequently operate mutual funds without such horrors arising, but that would have to await the future.

Ten years after the *Camp* decision, the Supreme Court held in *Board of Governors of Federal Reserve System v. Investment Company Institute*,[86] that the Fed could properly allow bank holding companies to advise closed-end investment companies concerning their investments because such advice did not involve the sale or distribution of securities by the bank.[87] However, in 1984, the Supreme Court held *in Securities Industry Association v. Board of Governors of the Federal Reserve Board*, [88] that commercial banks could not market commercial paper because it was a security under the Glass-Steagall Act. However, that was a temporary setback because the District of Columbia Circuit Court subsequently held that a bank could

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[84] 401 U.S. 617 (1971).

[85] 401 U.S. at 630. The Court stated that:

> The bank's stake in the investment fund might distort its credit decisions or lead to unsound loans to the companies in which the fund had invested. The bank might exploit its confidential relationship with its commercial and industrial creditors for the benefit of the fund. The bank might undertake, directly or indirectly, to make its credit facilities available to the fund or to render other aid to the fund inconsistent with the best interests of the bank's depositors. The bank might make loans to facilitate the purchase of interests in the fund. The bank might divert talent and resources from its commercial banking operation to the promotion of the fund. Moreover, because the bank would have a stake in a customer's making a particular investment decision -- the decision to invest in the bank's investment fund -- the customer might doubt the motivation behind the bank's recommendation that he make such an investment. If the fund investment should turn out badly there would be a danger that the bank would lose the good will of those customers who had invested in the fund. It might be unlikely that disenchantment would go so far as to threaten the solvency of the bank. But because banks are dependent on the confidence of their customers, the risk would not be unreal.

Id. at 637-38.

[86] Bd. of Gov. of the Fed. Reserve Sys. v. Inv. Co. Inst., 450 U.S. 46 (1981).

[87] For a discussion of the inroads by banks into the securities business in the 1980ssee Thomas G. Fischer, *et al*, The Securities Activities of Commercial Banks: A Legal and Economic Analysis, 51 Tenn. L. Rev. 467 (1983-1984).

[88] 468 U.S. 137, at 139-40 (1984).

distribute commercial paper on an agency basis, notwithstanding the prohibitions of the Glass-Steagall Act.[89]

Banking regulators concluded that banks could broker other securities for customers without falling afoul of the Glass-Steagall prohibitions against underwriting and dealing in stocks.[90] The Supreme Court also upheld the Federal Reserve's approval of BankAmerica Corporation's acquisition of Charles Schwab in *Securities Industry Association v. Board of Governors of the Federal Reserve System*.[91] Charles Schwab was a discount broker that only acted as a broker, but its nationwide operations opened the door for BankAmerica to participate broadly in the securities markets, thus encouraging several more banks to enter joint ventures with discount brokers.[92]

Another loophole soon opened up further intrusion by the banks into the securities industry. Section 16 of the Glass-Steagall Act allowed commercial banks to underwrite certain government securities called "bank-eligible" securities, a category that included state and municipal securities, and it permitted dealings in U.S. government and agency securities. Banks also used section 20 of the Glass-Steagall Act to circumvent that Act's restrictions on underwriting. By its terms, section 20 prohibited banks from affiliating with companies "engaged principally" in the "issue, flotation, underwriting, public sale or distribution" of "bank-ineligible"

Sec. Indus. Ass'n v. Bd. of Gov. of the Fed. Reserve Sys., 807 F.2d 1052 (D.C. Cir. 1986), *cert. denied*, 483 U.S. 1005 (1987). Ironically, commercial paper was largely exempt from regulation as a security under the federal securities laws *See* Sanders v. John Nuveen & Co., Inc., 463 F.2d 1075 (7th Cir.), *cert. denied*, 409 U.S. 1009 (1972).

[90] The Comptroller of the Currency determined in 1982 that the Security Pacific National Bank could operate a discount brokerage subsidiary. . *See* JANE W. D'ARISTA, 2 THE EVOLUTION OF U.S. FINANCE, RESTRUCTURING INSTITUTIONS AND MARKETS 311 (1994) [hereinafter D'ARISTA, VOL. II]. The Fed also ruled that discount brokerage services did not run afoul of the Bank Holding Company Act because, according to the Fed, they were closely related to bank activities. *See id.* at 77.

[91] Sec. Indus. Ass'n v. Bd. of Gov. of the Fed. Reserve Sys., 465 U.S. 1004 (1984).

[92] BankAmerica bought Schwab for $55 million in 1983 and resold it to Schwab management in 1987 for $280 million. *See* http://www.aboutschwab.com/about/overview/history.html.

securities like stock and corporate debt. In 1988, the Second Circuit upheld the Fed's determination that a security affiliate is principally engaged in bank-ineligible securities activities only when those activities exceeded five to ten percent of the affiliate's gross revenue.[93] That limit was increased to twenty-five percent in 1996, allowing some giant banks to acquire and operate some rather large broker-dealers.[94]

The SEC eventually became concerned about the banks' increased participation in the securities market. For this reason, it adopted a rule requiring banks engaging in the securities brokerage business to register with the SEC as broker-dealers. The District of Columbia Court of Appeals held that the SEC lacked the power to enact such a rule,[95] but the Competitive Equality Banking Act of 1987 imposed a one-year moratorium on further approvals by the Fed for additional bank securities activities.[96] That only temporarily slowed the intrusion of the banks into the securities arena.

Banking Intrusions

The Bank Holding Company Act prohibited bank holding companies from diversifying into non-traditional bank business without the Fed's approval.[97] That statute proscribed bank holding companies from holding shares of another company unless its activities were found by the Fed "to be so closely related to banking as to be a proper incident thereto."[98] Exempted from

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[93] Sec. Indus. Ass'n v. Bd. of Gov. of the Federal Res. Sys., 839 F.2d 47 (2d. Cir.), *cert. denied*, 486 U.S. 1059 (1988).

[94] *See* BROOME & MARKHAM, REGULATION OF BANKING, *supra* note __, at 719. A federal court also ruled in 1987 that the National Westminster Bank PLC and its subsidiary, NatWest Holdings, Inc., could provide investment advice and securities brokerage services to institutional customers without violating Section 20 of the Glass-Steagall Act. *See* Sec. Indus. Ass'n v. Bd. of Gov. of the Federal Res. Sys., 821 F.2d 810 (D.C. Cir. 1987), *cert. denied*, 484 U.S. 1005 (1988).

[95] *See* American Bankers Ass'n v. Securities and Exchange Comm'n, 804 F.2d 739 (D.C. Cir. 1986).

[96] *See* Competitive Equality Banking Act of 1987, Pub. L. 100-86, § 509(a), 101 Stat. 635 (codified in scattered sections of 12 U.S.C. and 31 U.S.C.).

[97] *See* D'ARISTA, VOL. II, at 69.

[98] 12 U.S.C. §1843(c)(8) (2006).

that provision were one-bank holding companies, which became a popular way to avoid restrictions imposed on banks, until Congress eliminated that exception; although it grandfathered existing one-bank holding companies.[99] Reverse competition came in the form of non-bank banks that did not meet the definition of a bank because they did not both accept deposits *and* make loans. [100]

The 1990s witnessed a series of other actions by regulators that further diminished the line between commercial and investment banking. The Bank Service Corporation Act permitted banks to operate bank service corporations that could perform back office services for banks and certain other activities.[101] The Comptroller adopted regulations in 1997 that permitted national banks to establish "operating subsidiaries" to engage in activities that a national bank could not engage in directly, including some insurance activities.[102] The Comptroller also allowed NationsBank to operate a subsidiary to develop residential condominiums.[103]

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[99] *See* Bank Holding Company Act Amendments of 1970. Pub. L. 91-607, 84 Stat. 1760 (codified at 12 U.S.C. §§ 1850, 1971-1978 (2006)) ; *see also* CHRISTOPHER ELIAS, THE DOLLAR BARRONS 162 (1973).

[100] Several stock brokerage firms, including Merrill Lynch, operated non-banks, but Congress acted to curb such activities for other than existing non-bank banks through the Competitive Equality Banking Act of 1987. P.L. 100-86, 101 Stat. 552. However, those curbs did not stop non-bank banks from generating the subprime loans that were at the center of the subprime crisis. These entities did not accept deposits. Rather, they financed their mortgage lending through borrowings from a Wall Street firm, and then securitized the mortgages through a "warehousing" operation with the investment bank. *See* PAUL MUOLO & MATHEW PADILLA, CHAIN OF BLAME (2008) (hereinafter "CHAIN OF BLAME") (describing this process).

The Competitive Equality Banking Act also allowed "industrial loan" companies to continue to operate. These companies could make loans as an adjunct to their sales of good. 12 U.S.C. §1841(c)(2)(H). Target and Nordstrom were among the companies using this exemption. The Obama administration has claimed that these entities pose a systemic risk and is seeking their regulation. Eric Lipton, *Citing Risks, U.S. Seeks New Rules For Niche Banks*, N.Y. TIMES, Sept. 17, 2009, at A1.

[101] *See* John D. Douglas, *Technology and Banking*, 1 N.C. BANKING INST. 59, 66-67 (1997).

[102] *See* J. Virgil Mattingly & Keiran J. Fallon, *Understanding the Issues Raised by Financial Modernization*, 2 N.C. BANKING INST. 25, 57 (1998); *see also* Note, *Functional Regulation of Bank Insurance Activities: The Time Has Come*, 2 N.C. BANKING INST. 455, 468 (1998).

[103] *See* JERRY W. MARKHAM, III A FINANCIAL HISTORY OF THE UNITED STATES, FROM THE AGE OF DERIVATIVES INTO THE NEW MILLENNIUM (1970-2001) 241 (2002) [hereinafter MARKHAM, VOL. III].

Several rulings by the Comptroller of the Currency and the Supreme Court permitted national banks to enter the insurance and annuities market.[104] Prior to these rulings, only certain state-chartered banks had been permitted to provide insurance services. The Garn-St. Germain Act of 1982 sought to prohibit federal bank regulators from further expanding the powers of banks into underwriting insurance as an activity that is "closely related to banking."[105] This precluded the Fed from authorizing bank holding companies from engaging in or being affiliated with companies that were underwriting insurance; although the act grandfathered activities already approved.

Before that legislation was enacted, the OCC had allowed banks to offer credit life insurance because it was an activity that was closely related to banking, and that action was upheld by the District of Columbia Circuit.[106] Even after Garn-St Germain, however, the OCC ruled that sales of credit insurance, municipal bond insurance, disability insurance and title insurance were incidental to the business of banking.[107] The Comptroller also approved an application by BancOne that allowed it to operate a subsidiary that planned to engage in reinsurance, which has the same effect as underwriting.[108] In 1995, the Supreme Court held that national banks could sell annuities.[109] One year later the Court ruled in *Barnett Bank of Marion*

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[104] *See generally* Lissa L. Broome & Jerry W. Markham, *Banking and Insurance: Before and After the Gramm-Leach-Bliley Act*, 25 J. CORP. L. 723 (2000).
[105] *See* Mattingly & Fallon, *supra*, n. – at 468.
[106] *See* Indep. Bankers Ass'n of Am. v. Heimann, 613 F.2d 1164 (D.C. Cir. 1980). The OCC extended that ruling to crop insurance, but the D.C Circuit ruled that the OCC had then gone too far, although noting that the newly enacted Gramm-Leach-Bliley Act might permit such activity. *See* Indep. Ins. Agents of Am., Inc. v. Hawke, 211 F.3d 638 (D.C. Cir. 2000).
[107] *See* Leigh Rabemacher, *Powers of National Banks to Sell Insurance, Annuities and Securities from Bank Premises*, 30 CREIGHTON L. REV. 753, 754 (1997) (citations omitted).
[108] *See* MARKHAM, VOL. III, *supra* note __, at 241.
[109] *See* NationsBank v. Variable Annuity Life Ins. Co., 513 U.S. 251 (1995).

County, N.A. v. Nelson,[110] that the states could not enact legislation that would prevent national banks from participating in the insurance business.

The Comptroller of the Currency had also ruled, in 1986, that national banks could sell insurance anywhere in the United States, as long as the sales were made from a bank or branch that was located in a town with a population of less than 5,000. This action was taken under a statute that many people thought had been repealed in 1918. The section was even omitted from the official United States Code compilation in 1952, but in 1993 the Supreme Court held that the provision was still in effect.[111] After that decision, the OCC allowed banks to create operating subsidiaries that would operate a general insurance agency from a place of 5,000 and use the nationwide branches of the bank for referrals.[112] The result of these inroads into the insurance industry was that some seventy percent of banks were offering some form of insurance product before enactment of the Gramm-Leach Bliley Act. Banks were then accounting for over twenty-five percent of annuity sales. [113]

Despite the Supreme Court's decision in *Investment Company Institute v. Camp*,[114] by 1993, banks had also become one of the largest sellers of mutual funds,[115] a product regulated by the SEC under the Investment Company Act of 1940.[116] Commercial banks in the 1990s could sell mutual funds directly to customers as agents or establish separate broker affiliates for brokering mutual fund shares. Banks could additionally provide investment advisory services to

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[110] Barnett Bank of Marion Cty., N.A. v. Nelson, 517 U.S. 25 (1996).
[111] *See* U. S. Nat'l Bank of Ore. V. Indep. Ins. Agents of Am., 508 U.S. 439 (1993).
[112] OCC Interpretative Letter, 1996 WL 655026 (1996).
[113] *See* BROOME & MARKHAM, REGULATION OF BANKING, *supra* note __, at 879.
[114] 401 U.S. 617 (1971).
[115] *See* Penny Lunt, *How Are Mutual Funds Changing Banks?*, A.B.A. BANKING J., June 1, 1993, available in 1993 WL 3004317.
[116] Investment Company Act of 1940, ch. 686, 54 Stat. 789 (codified at 15 U.S.C. 80a-1 *et seq*. (2006)).

their customers with respect to mutual funds. Banks offered "private label" mutual funds as well as those of other organizations.

Sixteen firms were operating mutual funds for banks in order to avoid Glass-Steagall prohibitions on bank underwriting activities. One such firm, Concord Holding Corp., was administering and distributing over $36 billion worth of mutual funds for banks in 1993. By then, one third of all mutual funds were being sold through banks.[117] Mellon Bank acquired the Dreyfus mutual fund complex in 1993 and became the largest bank manager of mutual funds, as well as the second largest asset manager in the United States. NationsBank Corp (now Bank of America) was selling some forty different mutual funds. Citibank was also selling a family of mutual funds.[118]

Financial Supermarkets

In approving a request by Chase Manhattan Bank to act as principal in a "commodity price index swap" with its customers, the Office of the Comptroller of the Currency noted in 1987 that:

> The 'business of banking' has changed drastically over the 124 years since the National Bank Act was enacted to support a national currency, and no one expects banks today to be restricted to the practices that then constituted the 'business of banking.' The adaptability of the national banking system will become increasingly important as advances in technology and telecommunications accelerate the rate of change.[119]

The Comptroller's Office adopted a statement by a court in which it was asserted: "'we believe the powers of national banks must be construed so as to permit the use of new ways of

[117] *See* MARKHAM, VOL. III, *supra* note at 239.
[118] *Id*. at 239-240.
[119] Letter from OCC to Margery Waxman, Sidley & Austin, dated July 23, 1987, quoted in Markham, *Banking Regulation, supra* note __, at 277.

conducting the very old business of banking.'"[120] The result was to turn banks into financial supermarkets.

Before the repeal of the Glass-Steagall Act in 1999, commercial banks were "selling stocks and bonds, providing advice on mergers and acquisitions, concocting new fangled financial products and trading."[121] Banks were underwriting and distributing loans and bonds; providing mezzanine financing to companies; engaging in foreign exchange trading in the inter-bank currency market; advising customers on mergers and acquisitions; and offering complex financial instruments.[122] Banks were acting as agents in private placements, sponsoring closed end investment funds and offering deposit accounts with returns that were tied to stock market performance.[123] Other bank and bank affiliate activities included euro dollar dealings, trust investments, automatic investment services, dividend investment services, dealing in swaps and other OTC derivatives and providing research services.[124]

Before GLBA, many of the larger banks were receiving from one-third to over fifty percent of their revenues from non-interest income. Among the things that the banking regulators found to be closely related to banking were the following: acting as an investment advisor; leasing personal or real property; acting as underwriter for credit life insurance and credit accident and health insurance related to an extension of credit; performing appraisals of real estate; arranging commercial real estate equity financing; providing individual retirement

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[120] *Id.* (citation omitted)
[121] Timothy L. O'Brien, *Chase's Global Pit Boss; Executive Leads Bank into High-Stakes Markets*, N.Y. TIMES, Jan. 16, 1998, at D1.
[122] *See* Markham, *Banking Regulation, supra* note __, at 250-51 (citations omitted). The banks were occasionally stymied by the courts in offering new products. *See e.g.*, Blackfeet National Bank v. Nelson, 171 F.3d 1237 (11th Cir.), *cert. denied*, 528 U.S. 1004 (1999) (banks could not underwrite retirement CDs).
[123] *Id.*
[124] *Id. See* MICHAEL G. CAPATIDES, A GUIDE TO CAPITAL MARKETS ACTIVITIES OF BANKS AND BANK HOLDING COMPANIES 185-86 (1993). *See also* Jerry W. Markham & David J. Gilberg, *Federal Regulation of Bank Activities In the Commodities Markets*, 39 BUS. LAWYER 1719 (1984) (describing such activities).

accounts and cash management services; providing tax planning and preparation services; operating an agency for collecting overdue accounts receivable; and operating a credit bureau.[125]

Gramm-Leach-Bliley

The banks had thoroughly breached the barriers erected by Glass-Steagall by the end of the 1990s. Citicorp Inc. then administered the coup de grâce when it announced its merger with the Travelers Group, a major insurance underwriter, to form Citigroup.[126] Commercial banks were still prohibited from owning insurance underwriting operations like those at Travelers, but the parties took advantage of a provision in the Bank Holding Company Act that granted a two-year period for a bank to divest itself of such operations when acquired, with provision for three one-year extensions by the Fed.[127]

Citigroup gambled that this merger would provide an incentive to Congress to act in order to avoid breaking up the Travelers Group. It worked. That merger occurred on April 6, 1998 and the Glass-Steagall Act was repealed by the Gramm-Leach-Bliley Act ("GLBA") on November 12, 1999.[128] Among other things, the GLBA removed insurance underwriting restrictions on the commercial banks.[129] It also repealed section 20 of the Glass-Steagall Act, thus allowing commercial banks to create "financial holding companies" and "financial subsidiaries" to provide any number of services, as long as they are "financial in nature" — even when those services constitute investment banking.[130] The banks underwriting operations were

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[125] *See* MARKHAM, VOL. III, *supra* note __, at 238.
[126] For a description of that merger see CIT Group, Inc. v. Citicorp, 20 F. Supp.2d 775, 784 (D.N.J. 1998).
[127] 12 U.S.C. §1842(a) (2006).
[128] *See* Michael Schroeder, *Congress Passes Financial Services Bill*, WALL ST. J., Nov. 5, 1992, at A2; The Gramm-Leach-Bliley Act of 1999, Pub. L. No. 106-102, 1999 U.S.C.C.A.N. (113 Stat.) 1338.
[129] 12 U.S.C. §1843(k)(4)(B).
[130] *See e.g*., Paul J. Polking & Scott A. Cammarn, *Overview of Gramm-Leach-Bliley*, 4 N.C BANK. Instit.C. Bank. 1 (2000); Adam Nguyen & Matt Watkins, *Financial Services Reform*, 37 HARV. J. LEG. 579 (2000).Ingo Wallenborn, *Competitiveness of U.S. Banks After Gramm-Leach-Bliley: A Comparison Between the U.S. and European Regulatory Systems*, 20 ANN. REV. BANKING L. 243, 251 (2001).

freed of the twenty-five percent limitation on revenue from bank ineligible activities. The result was that, within two years of the passage of GLBA, Citigroup passed Merrill Lynch as the nation's largest underwriter of stocks and bonds.[131]

GLBA opened the door for commercial banks to enter other areas of finance including, among other things, the ability to engage freely in commercial paper dealings[132] and to make limited merchant banking investments.[133] The issue now to be considered is whether the repeal of Glass-Steagall by the GLBA somehow freed the banks to engage in the activities that nearly destroyed them during the subprime crisis.

The Subprime Crisis

The subprime crisis was, without doubt, one of one of the gravest financial crises in history. Much of the blame for that crisis has been placed on the bursting of the residential real estate bubble, which was fueled in large part by the reckless expansion of subprime mortgage lending. Those mortgages dropped sharply in value as the Federal Reserve Board drove up interest rates, causing massive losses at, among others, Citigroup, Wachovia, Bank of America, Washington Mutual, American International Group ("AIG"), Merrill Lynch, Lehman Brothers, Countrywide Financial, IndyMac, Freddie Mac And Fannie Mae. A giant $700 billion bailout package passed by Congress in October 2008, called the Troubled Asset Recovery Program ("TARP") was used to inject capital into the largest financial institutions, including $25 billion into Citigroup and $173 million at AIG.[134]

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[131] *See* Randall Smith, *Citigroup Unseats Merrill Lynch as Top Stock, Bond Underwriter*, WALL ST. J., Dec. 28, 2001.
[132] *See* BROOME & MARKHAM, REGULATION OF BANKING, *supra* note __, at 795.
[133] 12 U.S.C. §1843(k)(4)(H) (2006).
[134] For a description of those evens see WESSEL, *supra* note ___, . The subprime crisis had other ripple effects. The Dow Jones Industrial average was down 47 percent on February 19, 2009 from the high of 14,087 that was reached on October 1, 2007.This devastated retirement savings, college and other endowments and every other investor in the market. *See* E.S. Browning, *Market Hits New Crisis Low*, WALL ST. J., Feb. 20, 2009, at A1.

Subprime borrowers began defaulting in large numbers, as their adjustable rate mortgages (which had been originally issued at low "teaser" rates) reset at unaffordable levels. Foreclosures became an epidemic in many communities across the country. Fueling the subprime lending boom were mortgage brokers promoting "no-doc" or "low doc" ("liar") loans that did not require the normal documentation of the borrower's creditworthiness. Credit quality was of no concern to the mortgage brokers and lenders making those loans because the loans were immediately resold by securitizing them in a pool, which was then sold to investors as a collateralized debt obligation ("CDO").[135]

The CDOs were often completed through so-called "warehouse" financing in which an investment bank loaned money to a subprime mortgage originator that generated subprime mortgages through mortgage brokers. Those mortgages were sold back to the investment banker and placed in the investment banker's warehouse until they could be securitized into a CDO. The CDOs often had complex payment streams, and they were frequently insured against default by "monoline" insurance companies or hedged by a new financial instrument in the form of credit default swaps ("CDS").[136] Those protections allowed the "Super Senior" tranches in

[135] For a description of the subprime mortgage market see MUOLO & PADILLA, *supra* note __.

[136] In a report to its shareholders, UBS AG described its CDO warehouse facility as follows:

> In the initial stage of a CDO securitization, the [CDO] desk would typically enter into an agreement with a collateral manager. UBS sourced residential mortgage backed securities ('RMBS') and other securities on behalf of the manager. These positions were held in a CDO Warehouse in anticipation of securitization into CDOs. Generally, while in the Warehouse, these positions would be on UBS's books with exposure to market risk. Upon completion of the Warehouse, the securities were transferred to a CDO special-purpose vehicle, and structured into tranches. The CDO desk received structuring fees on the notional value of the deal, and focused on Mezzanine ('Mezz') CDOs, which generated fees of approximately 125 to 150 bp (compared with high-grade CDOs, which generated fees of approximately 30 to 50 bp). Key to the growth of the CDO structuring business was the development of the credit default swap ('CDS') on ABS in June 2005 (when ISDA published its CDS on ABS credit definitions). This permitted simple referencing of ABS through a CDS. Prior to this, cash ABS had to be sourced for inclusion in the CDO Warehouse. Under normal market conditions, there would be a rise and fall in positions held in the CDO Warehouse line as assets were accumulated ('ramped up') and then sold as CDOs. There was typically a lag of between 1 and 4 months between initial agreement with a collateral manager to buy assets, and the full ramping of a CDO Warehouse.

subprime securitizations to obtain a triple-A credit ratings from the leading rating agencies, making them highly marketable in the U.S. and Europe.

Subprime mortgages were sometimes pooled to fund off-balance sheet commercial paper borrowings called "structured investment vehicles" ("SIVs") or "asset-backed commercial paper" ("ABCP"), as they were sometimes called. Banks, such as Citigroup, used short-term commercial paper borrowings to purchase mortgages that were placed in trust. The mortgages funded the commercial paper borrowings, providing a profit on the spread between the higher rates paid by mortgages and the lower rates then existing in the commercial paper market. There was a flaw in these carry trade programs. In the event that commercial paper borrowers refused to roll over their loans, the SIV would have to liquidate their mortgages. That roll over might not be possible in a major market downturn. Another danger was that short-term rates could rise faster than long-term rates, erasing the spread, or even inverting the payment stream.[137]

GLBA Critics

The blame game began even before the end of the subprime crisis. Some critics argued that it was the removal of the Glass-Steagall barriers by GLBA that allowed banks to enter into the subprime transactions that ultimately caused their massive losses. One leader of the anti-GLBA faction was the *New York Times*. In a front page story, that paper attacked Senator Phil Gramm, one of the sponsors of the GLBA, as having opened the door for the subprime crisis by deregulating a host of financial services.[138] Among other things, the article breathlessly reported that:

> In late 1999, Mr. Gramm played a central role in what would be the most significant financial services legislation since the Depression. The Gramm-Leach-Bliley Act, as the

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UBS AG, SHAREHOLDER REPORT ON UBS'S WRITE-DOWNS § 4.2.2 (Apr. 2008).

[137] *See* CHARLES R. MORRIS, THE TRILLION DOLLAR MELTDOWN 82-84 (2008) (describing SIVs and their flaws).

[138] *See* Eric Lipton & Stephen Labaton, *A Deregulator Looks Back, Unswayed*, N.Y. TIMES, Nov. 17, 2008, at A1.

> measure was called, removed barriers between commercial and investment banks that had been instituted to reduce the risk of economic catastrophes. Long sought by the industry, the law would let commercial banks, securities firms and insurers become financial supermarkets offering an array of services.[139]

Gramm was further charged by the *Times* with creating (through other legislation that was enacted in 2000) a loophole in that allowed credit default swaps, which destroyed AIG, to trade unregulated.[140] Gramm was unrepentant. He blamed the crisis on faulty monetary policy and the politicization of mortgage lending.[141]

Another critic of the GLBA was former Fed Chairman Paul Volcker who was serving asa the head of President Barack Obama's Economic Recovery Advisory Board. Volcker was advocating that commercial banking activities be separated from investment banking and that commercial banks not be allowed to own or trade "risky" securities. According to the *New York Times*, however, Volcker was unsuccessful in convincing the Obama administration to adopt such an approach,[142] and Fed Chairman Ben Bernanke was urging a "more subtle approach."[143] Nevertheless, Volcker's proposal was being supported by Mervyn King, Governor of the Bank of England.[144] U.S. Treasury Secretary Timothy Geithner was taking another approach, advocating granting bank regulators power to order large financial firms, even healthy ones, to sell off assets, if their size threatened the economy, a sort of tailored Glass-Steagall approach.[145]

European regulators were forcing large financial institutions bailed out during the subprime crisis to sell of non-core operations. The European Union required such divestments as

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[139] *Id.*
[140] *Id.*
[141] Phil Gramm, *Deregulation and the Financial Panic*, WALL ST. J., Feb. 20, 2009, at A17.
[142] *See* Louis Uchitelle, *Volcker Fails to Sell a Bank Strategy*, N.Y. TIMES, Oct. 21, 2009, at A1.
[143] *See* Stephen Labaton, *Trying to Rein in "To Big to Fail" Institutions*, N.Y. TIMES, Oct. 26, 2009, at A1, A3. For a discussion of the conflicting views over renewal of Glass-Steagall see David Wessel, *Three Theories on Solving 'Too Big to Fail" Problem*, WALL ST. J., Oct. 28, 2009, at A12.
[144] *Id.*
[145] *See* Damian Paletta, *U.S. Seeks Power to Force Even Strong Banks to Shrink*, WALL ST. J., Oct. 30, 2009, at A8.

a condition for state sponsored bailouts. For example, the Royal Bank of Scotland was required to sell its profitable insurance operations, a commodity trading unit, and a payment services firm.[146] The British government was breaking up Northern Rock, the bank that was nationalized during the subprime crisis as a result of subprime exposures, into a "good" bank and "bad" bank, so that assets could be sold.[147] The Dutch government ordered the ING Groep to be broken up after a $14.9 billion bailout of that company.[148]

IV

The Development of Mortgage-Backed Bonds

Nineteenth Century Bonds

In determining whether GLBA opened the door to the subprime crisis, some history is useful. The subprime CDOs did not spring out unannounced after the repeal of the Glass-Steagall Act in 1999. Such instruments have been around for a long time, and have proved to be problematic on more than one occasion. The mortgage-backed security concept comes to us from Europe. "By the mid-1800s mortgage-backed bonds that were issued by mutually owned institutions (*Landschaften*), privately-owned, joint-stock mortgage banks and a national monopoly bank (*the Credit Foncier*) traded in Germany and France at yields as low as government securities and in markets as thick and deep."[149]

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[146] Charles Forelle & Sara Munoz, *EU Sheds Soft Touch for Iron Fist on Banks*, WALL ST. J., Nov. 4, 2009, at C1.
[147] *See* Sharlene Goff, *Brussels Agrees N Rock Break-Up and Sale*, FIN. TIMES (London), Oct. 29, 2009, at 8.
[148] Ing's losses were largely attributable to subprime mortgage exposures in the United States. *See* Eric Dash and Chris Nicholson, *Post-Bailout Blues as Europe Orders ING Group to Sell 2 Units*, N.Y. TIMES, Oct. 27, 2009, at B1
[149] Kenneth Snowden, *What Can History Tell Us About the Crisis in Mortgage Securitizations?* FIN. HIST. MAGAZINE (Museum of Am. Fin., New York, N.Y.), Winter 2003, at 16.

The U.S. Mortgage Company was created by J.P. Morgan and others to sell high-yield mortgage backed bonds in Europe during the 1870s. The Equitable insurance company organized the Mercantile Trust for originating and selling mortgages in the United States. Both companies failed during the downturn in 1873 because of the poor quality of the mortgages they were selling.[150] More failures arrived in the 1890s, with the creation of mortgage companies that sold debentures that were backed by mortgages placed in trust accounts. One such firm was the J.B. Watkins Land Mortgage Company in Kansas. It placed the mortgages it originated in trust with the Farmers' Loan & Trust Co. in New York.[151] Debentures were then sold that were collateralized by the mortgages held in trust, a process that was used in this century to securitize subprime mortgages. J.B. Watkins suffered a liquidity crisis after the panic of 1893 because of the "nervousness of investors" who were calling in their loans.[152] Only seven of the seventy-four companies licensed for such business survived the 1890s, due largely to the poor quality of the mortgages placed in trust.[153]

In 1904, New York authorized property title insurance companies to insure mortgage payments The business of guaranteeing mortgages was an outgrowth of the title insurance business.[154] This statute laid the groundwork for a private mortgage insurance business that originated, insured, sold, and then serviced mortgages on both residential and commercial properties. Beginning in 1906, mortgages were being pooled and placed in trust, and interests in that trust were sold to investors in the form of collateral trust certificates. They were given an undivided share in the pool. "By 1913 some of these companies also placed mortgage loans in

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[150] *Id.* at 17.
[151] For a description of the Farmers' Loan & Trust Co. see Pollock v. Farmers' Loan & Trust Co. 157 U.S. 429, 430-431 (1895).
[152] *See Watkins Land Mortgage Co's Failure*, N.Y. TIMES, Apr. 8, 1894, at 13.
[153] *See* Snowden, *supra* note __, at 18.
[154] *Id.*

trust, insured the payments on these loans, and sold participation certificates in these mortgages."[155] These "certificated mortgages" could cover a single large commercial mortgage, a form of syndication, or a group of small residential loans and could be packaged in much the way modern securitizations work.

The mortgage guarantee business began booming during World War I. The number of mortgage guarantee companies in New York quintupled in the 1920s "and the volume of outstanding mortgage loan insurance grew from $.5 to nearly $3 billion; $.8 billion of this total was written on certificated mortgages."[156] The Bond & Mortgage Guarantee Company guaranteed mortgages sold to investors by the Title Guarantee & Trust Company. It was guaranteeing more than $2 billion of mortgages that were sold to savings banks and other investors.[157] This was the precursor of the monoline insurance companies that would be at the center of the subprime crisis in 2007.

The 1920s

Real estate bonds issued by investment banking firms were funding commercial real estate developments in the 1920s. Initially, these real estate bonds covered only specific property, but were later expanded to include several properties under mortgage. One program allowed investors to obtain a real estate bond for $1000 that entitled them to participate in 122 different mortgages.[158] The issuer of the bonds often agreed to repurchase the bonds at a discount in order to provide liquidity and make the bonds more attractive to investors.

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[155] *Id.*

[156] *Id.*

[157] MARKHAM, VOL. II, *supra* note __, at 147. The Bond & Mortgage Guarantee Co. reported profits of over $1 million in 1920 and 1921. *See Bond & Mortgage Guarantee Co.,* N.Y. TIMES, March 29, 1922, at 33.

[158] *See* MARKHAM, VOL. II*, supra* note __, at 147.

S.W. Straus & Co. was offering bonds in the 1920s that had only second and third mortgages on commercial real estate and then it offered bonds secured only by "general mortgages" and collateral trust bonds that were secured by subordinated mortgages. "Typically a Straus bond yielded 6 percent, twice the rate paid on a commercial-bank saving deposit and more than two percentage points higher than the rate offered by savings banks."[159] Mortgage bonds were being issued in large amounts for overvalued properties, allowing the promoters to use the bonds to pay for the land, buildings and even provide a profit. The real estate bonds were often supported by unreliable appraisals of the property, and problems associated with the properties were frequently not disclosed.[160]

The New York Attorney General warned in 1927 that some real estate bond firms were over-valuing properties. The industry then developed a code of conduct that the bond houses agreed to follow.[161] Such codes of conduct became popular with the New York Attorney General, Andrew Cuomo, during the subprime crisis. Difficulties had arisen in 1926, when a real estate bond in Florida defaulted during the market downturn in that state. The problem spread to New York as the real estate market softened. Several real estate bond houses failed, including G.L. Miller & Co., the American Bond & Mortgage Company, and the Empire Bond & Mortgage Company. G.L. Miller & Co. turned out to be little more than a Ponzi scheme. It and other real estate bond firms were the targets of investigation by the New York state attorney general and by a committee of the American Construction Council headed by Franklin D.

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159 JAMES GRANT, MONEY OF THE MIND, BORROWING AND LENDING IN AMERICA FROM THE CIVIL WAR TO MICHAEL MILKEN 161 (1992)
160 *See* MARKHAM, VOL. II*, supra* note __, at 147.
161 *See* Snowden, *supra* note __, at 18.

Roosevelt.[162] Another failure was the New York Real Estate Securities Exchange, which opened on October 1, 1929. Located at 12 East 41st Street, this exchange had a large trading floor and established listing requirements for real estate mortgage companies and trust securities. That exchange failed after the Stock Market Crash of 1929 that occurred less than a month after this exchange opened.[163]

The mortgage guarantee companies in the 1920s were regulated by the New York State Department of Insurance. That regulator halted further mortgage guarantees in 1933 as those companies began defaulting. The New York Insurance Department took over control of eighteen companies engaged in the business of guaranteeing and selling mortgages and mortgage certificates.[164] The Moreland Act of 1907 authorized the New York governor to appoint a "Moreland commissioner" to investigate a broad range of activities. Such a commissioner was appointed by New York Governor Herbert H. Lehman to investigate the collapse of the mortgage bond and mortgage guarantee market in that state. Ironically, Lehman was the son of one of the founders of the Lehman Brothers investment banking firm, which would be destroyed by the mortgage-backed bonds that were at the center of the subprime crisis. The Moreland commissioner found that, as of December 31, 1933, there were over $800 million of outstanding mortgage certificates held by 212,874 investors and covering 9,435 issues, most of which were in default.[165]

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[162] JAMES GRANT, MONEY OF THE MIND, BORROWING AND LENDING IN AMERICA FROM THE CIVIL WAR TO MICHAEL MILKEN 168 (1992)

[163] *Id*. at 169-170.

[164] *See* Snowden, *supra* note __, at 18.

[165] *See* GEORGE W. ALGER, REPORT OF THE MORELAND COMMISSIONER 3 (Oct. 5, 1934). The Moreland commissioner found that mortgage bonds were often backed, in whole or in part, by vacant land that produced no income. The commissioner also found that appraisals were often out of date and based on prices that had sharply declined. In some instances, appraisal figures were arrived at by simply multiplying the amount of the loan by 150 percent, the statutory minimum, without any inspection of the property. Many properties on which mortgage bonds were sold in 1932 and 1933 were already in default when sold to investors. *See* David Saperstein, Director, Trading

The House of Representatives appointed a Select Committee to investigate real estate bondholders' reorganizations in 1934, following a protest by 10,000 defaulted bondholders in Chicago. Headed by Congressman Adolf J. Sabath from Illinois, the Select Committee held hearings in Detroit, New York, Chicago and Milwaukee. It found that some $10 billion in real estate bonds were outstanding and that $8 billion were in default, affecting about nine million investors, many of modest means.[166] The leading issuers of those bonds were George M. Forman & Co., Greenebaum Sons Investment Co., American Bond & Mortgage Co., Central Trust Co., S.W. Straus & Co., H.O. Stone & Co. and Lackner Butz & Co. The Select Committee was concerned with abuses by so-called "protective committees" that were formed ostensibly to protect the interests of defaulted mortgage bond owners, but were fraught with abuse through excessive fees and expenses. Over 10,000 protective committees were formed between 1929 and 1933. The Sabath investigation led to legislation that was incorporated in the Chandler Act in 1938, which gave the SEC an oversight role in corporate reorganizations.[167] The Chandler Act was repealed in 1978.[168]

Government Sponsored Enterprises

The Great Depression resulted in an almost complete collapse of the banking system. By the end of February 1933, it was common to see depositors standing "in long queues with satchels and paper bags to take gold and currency away from the banks to store in mattresses and old shoeboxes. It seemed safer to put your life's savings in the attic than to trust the greatest

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and Exchange Division, Real Estate Bond Issues of the Future, Address Before the National Mortgage Board of the National Association of Real Estate Boards (Oct. 23, 1935).

[166] *See* U.S. GOVERNMENT PRINTING OFFICE, FINAL REPORT OF THE SELECT COMMITTEE TO INVESTIGATE BONDHOLDER REORGANIZATIONS 521-23, (May 16, 1938) .

[167] *Id.*

[168] Chandler Act of 1938, Pub. L. No. 75-696, 52 Stat. 840, *repealed by* Bankruptcy Reform Act of 1978, Pub. L. 95-598, 92 Stat. 2549.

financial institutions in the country."[169] Such sights would not be witnessed again until the subprime crisis in 2007 touched off such a bank run in England. By 1933, over 500,000 home mortgages had been foreclosed. At one point, mortgages were being foreclosed at a rate of 1,000 per day.[170] "By 1933 the mortgage market had effectively ceased to function.[171] Between 1929 and 1933 the stock of mortgage loans declined fifteen percent and housing construction dropped eighty percent."[172]

Several steps were taken to deal with the residential housing crisis. The Federal Home Loan Bank Board ("FHLBB) was created in 1932 to restart mortgage lending by the savings and loan associations.[173] The Home Owners Loan Act of 1933 created the Home Owner's Loan Corp. (HOLC) to stop the massive foreclosures that were then occurring on home mortgages by replacing defaulted or troubled mortgages with new mortgages on terms that the homeowners could meet.[174] The National Housing Act of 1934, created the Federal Housing Administration ("FHA") to insure residential mortgages against default, a mission that it is carrying out today.[175]

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[169] However, those foreclosures provided little relief to lenders because the properties, once taken over, were usually worth only a fraction of the debt they secured. "In the conditions then prevailing, many of them could not be sold at any price." Note, *Riches Do Not Last Forever: Real Estate Investment by National Banks*, 1991 U. ILL. L. REV. 777, 783 (1991).

[170] *See* FEDERAL HOUSING ADMINISTRATION, THE FHA STORY IN SUMMARY (1934-1959) 1 (1959).

[171] As would be the case in the subprime crisis, many loans had been extended to borrowers who could not afford them:

> "[T]he attempt, fostered largely by financially interested groups on sentimental or emotional grounds, to extend homeownership to classes unable to afford it on the available terms and to sell others more expensive properties than they could afford, which has resulted in the assumption by many of debt charges far beyond their capacity to bear and thus swelled the volume of foreclosures, increased the fluctuations in real estate values, and destroyed the home-ownership aspirations of others with adequate financial resources to undertake it."

E.S. Wallace, *Survey of Federal Legislation Affecting Private Home Financing Since 1932*, 5 LAW & CONTEMP. PROBS. 481, 482 (1938).

[172] *See* P. BOSWORTH, THE ECONOMICS OF FEDERAL CREDIT PROGRAMS 48 (1987).

[173] The FHLBB advanced almost $450 million to its members between 1932 and 1938, with the peak outstanding amount reaching $200 million. However, those lending operations were said to be merely "a small tea kettle full of hot water to pour on the iceberg of frozen home loans." E.S. Wallace, *supra* note __, at 488.

[174] HOLC spent $3.1 billion to refinance mortgages on more than one million homes between 1933 and 1936. *See* MARKHAM, VOL. II, *supra* note __, at 172.

[175] *Id.*

Another Depression era agency, the Reconstruction Finance Corporation ("RFC") created the National Mortgage Association in 1938. The name of that entity was quickly changed to the Federal National Mortgage Association, and is now universally referred to as "Fannie Mae." That entity was authorized to buy FHA guaranteed loans from mortgage lenders. It funded those operations through sales of bonds to the public. This allowed mortgage lenders to originate mortgages that were guaranteed and then sold to the government. The government resold those mortgages to private investors around the country, thereby substantially expanding the ability to raise funds beyond the deposit base of individual lenders. Once the loans were purchased, the mortgage lender could use the funds received from their sale to make additional mortgages, thereby substantially expanding the mortgage market.[176]

Congress rechartered Fannie Mae in 1968 to become a privately owned company funded by private investors. It was listed on the New York Stock Exchange. Fannie Mae's charter required it to "'channel [its] efforts into increasing the availability and affordability of home ownership for low-, moderate-, and middle-income Americans.'"[177] Reaching that goal caused Fannie Mae to fail during the subprime crisis. In the meantime, the banking industry faced a number of setbacks after inflation became a problem in the 1960s, resulting in the creation of another giant government sponsored enterprise. A credit crunch occurred in 1966 that curbed mortgage lending and sharply reduced housing starts. Things seemed to have gotten better in 1967, but another credit crunch hit in 1968. The Government National Mortgage Association ("Ginnie Mae,' sometimes also called "GNMA") was created by the Housing and Urban Development Act of 1968. Ginnie Mae was made a part of HUD. Ginnie Mae did not itself

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[176] *See* Fred Wright, *The Effect of New Deal Real Estate Residential Finance and Foreclosure Policies Made in Response to the Real Estate Conditions of the Great Depression*, 57 ALA. L. REV. 231, 259 (2005).
[177] Jason T. Strickland, *The Proposed Revelatory Changes to Fannie Mae and Freddie Mac: An Analysis*, 8 N.C. BANKING INST. 267, 270 (2004) (citations omitted).

originate loans. Rather, it acted as a guarantor of loans originated in the private sector, but which had federal involvement from the Federal Housing Authority, the Veterans Administration, and other government-sponsored programs that were encouraging broader access to credit by particular segments of society.[178]

In 1969, interest rates reached historic levels, further reducing mortgage lending.[179] The Emergency Home Finance Act of 1970[180] was passed to relieve this situation. Among other things, this legislation created the Federal Home Loan Mortgage Corporation (Freddie Mac) for the purpose of providing a mechanism for the purchase of mortgage loans from savings institutions. It too was allowed to purchase conventional mortgages and guarantee them, but not with an explicit guarantee from the federal government. However, it also had an implicit government guarantee, and it too would fail during the subprime crisis.

Securitizing Mortgages

The securitization concept is not a new one. The process essentially involves the sale of a future stream of payments, or some other asset, whose value will be realized in the future. An early example of securitization was found in Amsterdam in the Seventeenth Century. There, a corps of women recruited sailors for the Dutch East India Company by luring them off the streets through promises of food, shelter, drink and sex. The women were paid a portion of the future wages of their recruits. The right to receive those payments was evidenced by a marketable security issued by the company that was called a *transportbrief*. Those securities were purchased by *zielkoopers* (buyers of souls) at a discount that reflected the high death rate of the sailors. By pooling the securities, the *zielkoopers* were able to diversify their risks. However, a rising mortality rate for

[178] *See* Christopher L. Peterson, *Predatory Structured Finance*, 28 CARDOZO L. REV. 2185, 2191-99 (2007).
[179] *See* Richard W. Bartke, *Fannie Mae and the Secondary Mortgage Market*, 66 NW. U. L. REV. 1 (1971).
[180] Pub. L. No. 91-531, 303(a) Stat. 450, 452 (codified as amended at 12 U.S.C. 1452

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the sailors bankrupted many of these merchants. Subprime lenders would have a similar experience in this century.[181]

A conceptually similar concept was adopted by Ginnie Mae when it began the sale of pooled mortgages in the United States in 1970 in the form of "pass-through certificates" that gave an investor a pro rata portion of the principal and interest payments received from mortgages placed in the pool.[182] This process allowed lenders to originate loans, to sell the loans through Ginnie Mae, and then to use the proceeds of that sale to originate more loans. The certificates guaranteed by Ginnie Mae were called "pass-through" because they simply passed the monthly mortgage payments on the mortgages held in the pool onto the certificate holders.[183] This meant that the certificate holder received monthly interest payments plus an amortized portion of the principal on the mortgage. In initial stages, the principal payments were only a small portion of the monthly payment but, as the principal on the mortgage was reduced over time, the portion of the principal payment grew each month. This payment stream raised some complex yield issues and reinvestment concerns.

Many mortgages are paid off before their maturity because homeowners move or purchase a more expensive home as their income grows. Homeowners also refinance their mortgages when interest rates drop. This results in a return of principal on that mortgage, which is then passed through to the holders of Ginnie Mae certificates. The holder of the certificate then had to reinvest those funds. If interest rates had dropped since the purchase of the pass-through certificate, then reinvestment would have to be made at the then existing lower interest rate,

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[181] *See* WILLIAM J. BERNSTEIN, A SPLENDID EXCHANGE: HOW TRADE SHAPED THE WORLD 235-236 (2008).

[182] *See* Ginniemae, The Pioneer of Mortgage-Backed Securities, http://www.ginniemae.gov/about/history.asp?subTitle=About (last visited Oct. 30, 2009).

[183] Comment, *Ask Not What Your Government Can Do for You, Ask What Your Government Can Do for Small Business: A Proposal for Government Involvement in the Securitization of Conventional Small Business Loans*, 2 FIU L. REV. 143, 147 (2007).

which displeased the certificate holder. This created a reinvestment risk. Because of this repayment feature, pass-through securities did not react in the same manner as corporate bond prices when interest rates fell. Bond prices generally increase when interest rates fall because the holder is now receiving a higher interest rate than is available in the market. In contrast, pass-through certificates may not increase at the same rate because there will be a greater prepayment of principal from accelerated refinancings that must be reinvested at lower market rates.

Freddie Mac sought to address the investment concerns associated with the pass-through securities developed by Ginnie Mae. Freddie Mac began offering "collateralized mortgage obligations" (CMOs) also known as "real estate mortgage investment conduits" (REMICs). The CMO was a product that was created for Freddie Mac, in 1983, by Larry Fink, who was then working at First Boston Corp. Fink went on to head BlackRock Inc., the giant asset manager, and played a prominent role in managing distressed pooled mortgage assets during the subprime crisis.[184]

The CMO instrument divided principal and interest payments from the mortgages placed in the pool into different payment streams. Unlike pass-through securities, principal and interest payments were not passed through to CMO investors pro rata. Instead, the CMO mortgage payments were divided into separate tranches with varying payment streams and with differing maturities, seniority, subordination, or other characteristics. This allowed investors to choose between a longer-term investment and one with a shorter term. The long-term investor was given some protection from prepayment risks by a requirement that principal repayments first be directed to the short-term investors. Only when they were completely paid off would the longer-term tranches start receiving principal payments.

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[184] *See* Katrina Booker, *Can This Man Save Wall Street?* FORTUNE, Nov. 10, 2008, at 102.

CMOs were popular after they were introduced in 1986 and 1987. The CMO concept was designed to guard against the prepayment risk. However, investors lost sight of a different risk posed by such securities. There is an "extension" risk, which is the opposite of the prepayment risk. Extension risk occurs where there is an unusual increase in interest rates. In such event, homeowners will be reluctant to sell their homes or to refinance them because they will have to pay a higher interest rate on a new mortgage. This means the certificate holder will be locked in for a longer than predicted period of time. That will cause a drop in the value of the certificate, due to the fact that the certificate holder will be receiving a lower rate than what prevails in the market for a longer than predicted time.[185]

Interest rates had been stable in the years following the introduction of the CMO. That situation changed on February 4, 1994, when the Federal Reserve Board increased short-term interest rates for the first time in five years. The Federal Reserve Board then embarked on a series of rate increases that had some disastrous effects on the bond markets. CMOs were crushed by these increases because they virtually stopped mortgage repayments, extending the average maturity of CMOs.[186] A valuation problem surfaced during the collapse of the CMO market. Some of the tranches in the CMOs were so complex that Goldman Sachs had to use multiple supercomputers to run simulations of cash flows under different interest-rate scenarios.[187] That problem presaged the valuation issues that would emerge during the subprime crisis in 2007.

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[185] *See generally* Banca Cremi, S.A. v. Alex. Brown & Sons, Inc., 132 F.3d 1017 (4th Cir. 1997) (describing these risks. CMOs often contained exotic tranches, including inverse floaters and inverse interest-only strips that converted fixed rate mortgages into floating rate tranches. *See* CHARLES MORRIS, THE TRILLION DOLLAR MELTDOWN 39-41 (2008).

[186] *See* Morris, *supra* note __, at 42.

[187] *See* MARKHAM, VOL. III, *supra* note __, at 144.

V

Glass-Steagall and Bank Securitizations

Private Issue Mortgage-Backed Securities

Mortgage backed securities issued by commercial banks had appeared well before the GLBA repealed the Glass-Steagall Act. "In 1977, Bank of America and Salomon Brothers first issued 'a security where outstanding loans were held in trust, with investors as beneficiaries.'"[188] National banks were actually encouraged to begin their own private mortgage-backed securitizations after Congress amended the banking laws in 1982 to allow those banks to "make, arrange, purchase or sell loans or extensions of credit secured by liens on interests in real estate," subject to limitations imposed by the OCC.[189] In addition, in 1984, Congress passed the Secondary Mortgage Market Enhancement Act ("SMMEA")[190] that sought "to allow private issuers of mortgage securities to compete effectively with government-related agencies, which had come to dominate the market, by removing some of the legal impediments to issuing private mortgage-backed securities."[191]

In *Securities Industry Association v. Clarke*,[192] the Second Circuit upheld a 1987 determination by the OCC that the Glass-Steagall Act did not bar a national bank from selling

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188 Jennifer Cummins, *Historical Changes Within the Credit and Investment Markets*, 27 REV. BANKING & FIN. L. 21, 25 (2008) (citation omitted).
189 P.L. 97-320, codified at 12 U.S.C. §371(a) (2006).
190 Pub. L. No. 98-440, 98 Stat. 1689 (codified at 12 U.S.C. §24).
191 Cummins, *supra* note __, at 26. S*ee also* KENNETH G. LORE, MORTGAGE-BACKED SECURITIES, DEVELOPMENTS AND TRENDS IN THE SECONDARY MORTGAGE MARKET (1994).
192 885 F.2d 1034 (2d Cir. 1989), *cert. denied*, 493 U.S. 1070 (1990).

mortgage-backed securities.[193] The court noted that national banks have long been viewed to have the incidental power to sell mortgages.[194] The Court stated that:

> "The popularity of the mechanism confirms what seems apparent, that many investors who might be wary of the risk of investing in a single mortgage loan will be willing to invest in a pool of loans. With the increased marketability that pass-through certificates make possible comes increased liquidity, an important benefit as banks face the task of funding long term mortgage loans with short term deposits."[195]

Over $1 trillion of asset-backed securities involving family mortgages were outstanding in 1991. NationsBank (now Bank of America) securitized $1.4 billion of commercial real estate mortgages in 1996 and $800 million in other mortgages.[196] From this analysis, it appears that GLBA was not a factor in commercial banks underwriting CMOS or their successor the CDO. Further analysis is needed to determine if GLBA was a significant factor in allowing commercial banks to securitize subprime loans as opposed to the more traditional conventional mortgages.

Subprime Mortgage Lending

Another consideration is whether GLBA allowed the commercial banks to enter the subprime mortgage market. Historically, subprime lending was avoided by most commercial banks because of the credit risks associated with such loans. A subprime loan is one that has a high likelihood of default because the borrower is not creditworthy Although there are no uniform standards for classifying a loan as subprime, a loan is generally viewed to be such if the borrower falls within one of the following categories: (1) those with a poor credit history; (2)

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193 A student comment also concluded in 1987 that, notwithstanding Glass-Steagall, banks had the authority to issue and to underwrite, but *not* to deal in, their own CMOs or to issue, underwrite, or deal in third-party CMOs. *See* Comment, *Collateralized Mortgage Obligations: Probing the Limits of National Bank Powers Under the Glass-Steagall Act*, 36 CATH. U. L. REV. 1025, 1030 (1987).
194 *See Clarke*, 885 F.2d at 1044 (citing First Nat'l Bank v. City of Hartford, 273 U.S. 548, 560 (1927)).
195 *Clarke*, 885 F.2d at 1049.
196 MARKHAM, VOL. III, *supra* note __, at 240.

those with no credit history; and (3) borrowers who have existing credit but who are over extended.[197] FICO credit scores are also used to identify subprime borrowers.[198]

To avoid losses from risky subprime loans loans, large banks traditionally "redlined" areas of the communities where subprime borrowers lived, and refused to make mortgage loans in those areas.[199] Minorities were often concentrated in the redlined areas, and this practice came to be viewed as racially discriminatory.[200] In order to stop the practice of redlining, the Home Mortgage Disclosure Act of 1975 (HMDA)[201] required banking institutions in metropolitan areas to disclose their mortgage loans by classification and geographic location, which disclosures it was thought would reveal discriminatory lending patterns.

The Community Reinvestment Act (CRA) of 1977[202] went a step further by requiring affirmative action by banks in meeting the credit needs of minorities in their service areas. Loans to subprime areas were made a statutory condition by the CRA for receiving approval from bank

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[197] *See* Note, *The Entrance of Banks Into Subprime Lending: First Union and the Money Store*, 3 N.C. BANKING INST. 149, 150-51 (1999). FICO credit scores are also used to identify subprime borrowers. *See* In re Countrywide Fin. Corp. Sec. Litig., 2008 U.S. Dist. LEXIS 102000 (C.D. Cal. 2008).

[198] As one court noted:

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

In re Countrywide Financial Corporation Securities Litigation, 2008 U.S. Dist. LEXIS 102000 (C.D. Cal. 2008).

[199] The Federal Housing Administration had employed a similar practice of denying mortgage insurance in poorer communities. *See* Ngai Pindell, *Is There Hope for HOPE VI?: Community Economic Development and Localism*, 35 CONN. L. REV. 385, 399,n.76 (2003) ("The FHA extended the segmentation of neighborhoods through redlining. In providing insurance to private lenders for long-term mortgage loans, the FHA disfavored areas occupied by racial minorities.").That practice was later changed to direct FHA insurance to subprime borrowers. *See* Kerry D. Vandell, *FHA Restructuring Proposals: Alternatives and Implications*, 6 HOUSING POL'Y DEBATE 299 (1995).

[200] *See generally* Nat'l State Bank, Elizabeth, N.J. v. Long, 630 F.2d 981(3d Cir. 1980) (describing this practice).

[201] Home Mortgage Disclosure Act of 1975, Pub. L. 94-200, 89 Stat. 1125 (codified at 12 U.S.C. §§ 2801-2811 (2006)).

[202] Community Reinvestment Act of 1977, Pub. L. 95-128, 91 Stat. 1147 (codified at 12 U.S.C. §§ 2901 *et seq.* (2006)).

regulators bank mergers.[203] That legislation did not prove to be immediately effective in expanding subprime lending, because banks continued to shy away from the credit risks associated with such loans. The Clinton administration, however, overcame that resistance through its National Homeownership Strategy, which sought to boost homeownership by minorities, and thereby increase the percentage of owner-occupied residences to 67.5 percent by the year 2000.[204] That strategy was assisted by new CRA requirements, which, "in the words of the Federal Reserve Governor who wrote the regulations, set up soft quotas on lending in underserved areas."[205]

The Clinton administration's CRA efforts led to an eighty percent increase in the number of subprime mortgages.[206] "Subprime mortgage originations grew from $35 billion in 1994 to $140 billion in 2000, indicating an average annual growth rate of 26%."[207] The Federal Reserve Board advised banks that CRA loans were to be made in a safe and sound manner.[208] That admonition begged the question: how do you make a safe and sound subprime loan when, as Fed

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

[204] *See* William J. Clinton, U.S. President, Remarks at the White House on the National Homeownership Strategy (June 5, 1995), *available at* http://www.presidency.ucsb.edu/ws/index.php?pid=51448.

[205] Congressional Senate Oversight Committee, Hearings on Regulation of the Financial Sector, Jan. 14, 2009, visited at http://www.lexis.com/research/retrieve?_m=e 1179c9a3f8ef7bfac700bbc4b3bab8d&docnum =1&_fmtstr=FULL&_startdoc=1&wchp=dGLbVlbzSkAz&_md5=993b42918333c497475d06cebd3b6121&focBudTerms=clinton%20 administration%20and%20subprime%20&focBudSel=all.

[206] Roberta Achtenberg, a HUD assistant secretary established a nationwide CRA enforcement program that was designed to force banks to make subprime loans. As one author asserts:

> Banks were compelled to jump into line, and soon they were making thousands of loans without any cash-down deposits whatsoever, an unprecedented situation. Mortgage officers inside the banks were forced to bend or break their own rules in order to achieve a good Community Reinvestment Act rating, which would please the administration by demonstrating generosity to underprivileged borrowers even if they might default. Easy mortgages were the invention of Bill Clinton's Democrats.

Lawrence G. McDonald & Patrick Robinson, *supra* note __, at 4.

[207] *Subprime Mortgage Lending and the Capital Markets*, RBSF Economic Letter, December 28, 2001, http://www.frbsf.org/publications/economics/letter/2001/el2001-38.html#subhead.1 (last visited Oct. 25, 2009).

[208] Federal Reserve Board, Community Reinvestment Act. ("Nor does the law require institutions to make high-risk loans that jeopardize their safety. To the contrary, the law makes it clear that an institution's CRA activities should be undertaken in a safe and sound manner."), visited at http://www.federalreserve.gov/dcca/cra/.

Chairman Ben Bernanke has candidly admitted those borrowers pose a "high credit risk?"[209] The solution for this counterparty risk problem was solved by the Clinton administration when CRA regulations were amended in 1995 to allow CRA based subprime loans to be securitized. Securitization provided the banks with a way to move subprime loans off their balance sheets, and it allowed "lenders to shift mortgage credit risk and interest rate risk to investors who have greater risk tolerance."[210] Once again, it seems clear that GLBA played little, if any, role in the development of the CDO market for subprime mortgages.

Commercial banks were soon making massive CRA commitments. For example, Washington Mutual made a CRA pledge of $120 billion in its 1998 acquisition of HF Ahmanson & Co.[211] The merger of Citibank and the Travelers Group in 1999 resulted in a ten year $115 billion CRA pledge.[212] Bank of America made a ten-year CRA subprime lending pledge of $750 billion when it merged with FleetBoston Financial Corp. in 2003.[213] JPMorgan Chase made a larger $800 billion CRA pledge when it merged with Bank One Corp. in 2004.[214] One website, which is highly critical of these pledges, claims that total CRA commitments by banks reached $4.2 trillion by 2004.[215]

The Federal Reserve Board has contended that the CRA did not cause the subprime crisis because many subprime loans did not have CRA credit.[216] One author argues that the CRA was

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[209] *The Subprime Mortgage Market*, Address by Fed Chairman Ben S. Bernanke At the Federal Reserve Bank of Chicago's 43rd Annual Conference on Bank Structure and Competition, Chicago, Illinois, May 17, 2007.

[210] Division of Insurance and Research of the Federal Deposit Insurance Corporation, *Breaking New Ground in U.S. Mortgage Lending*, FDIC OUTLOOK (Fed. Deposit Ins. Corp.), Summer 2006, at 21.

[211] *See* Jaret Seiberg, *Minority Report*, THE DAILY DEAL, Nov. 3, 2003.

[212] *See* BROOME & MARKHAM, REGULATION OF BANKING *, supra* note __, at 405-406.

[213] *See* Craig Lender, *In Brief: B of A Chief Raps CRA Overhaul*, AM. BANKER, Apr. 26, 2004, at 8.

[214] *See* BROOME & MARKHAM, REGULATION OF BANKING *, supra* note __, at 405-406.

[215] http://www.vdare.com/sailer/090215_cra.htm.

[216] Randall S. Kroszner, Fed. Reserve Gov., The Community Reinvestment Act and the Recent Mortgage Crisis, Address Before the Confronting Concentrated Poverty Policy Forum (Dec. 3, 2008). Both the Clinton and Bush (43) administrations also pushed toward more subprime lending by two giant government sponsored enterprises ("GSEs"), Fannie Mae ad Freddie Mac. By 2000, about fifty percent of their portfolios were subprime products. .

not responsible for subprime crisis because (1) few CRA loan applications were denied, which the author seems to suggest demonstrates they were good loans; (2) many of the players in the subprime market were not regulated banks; and (3) most subprime loans originated in California, Florida and Nevada, suggesting that since CRA had little effect elsewhere, it was not to blame.[217] These claims overlook the fact that the CRA required, and thereby legitimatized, subprime lending by institutions that had previously shied away from such risky loans. As former Fed Chairman Alan Greenspan testified before Congress in October 2008: "Its instructive to go back to the early stages of the subprime market, which has essentially emerged out of the CRA."[218]

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After being forced into the market by the federal government, banks found the business to their liking. This was another unfortunate legacy of the CRA. Former Senator Phil Gramm noted that: "It was not just that CRA and federal housing policy pressured lenders to make risky loans—but that they gave lenders the excuse and regulatory cover" to enter what was appearing to be a lucrative business in which risks could be managed through securitizations.[219] The proof is in the pudding. Subprime lenders were initially an industry unto themselves because large banks avoided such lending, until the CRA pushed them into it. There were only ten lenders in the subprime market in 1994, but their numbers increased to fifty by 1998. By 2001, as the result of the CRA, ten of the twenty-five largest subprime lenders were banks or their affiliates.[220]

It seems clear from these numbers that Glass-Steagall imposed no significant barrier to commercial banks in making subprime loans. Indeed, GLBA tried to stop some abuses

See The Subprime Lending Bias, INVESTOR'S BUSINESS DAILY, Dec. 22, 2008, at A14. That quota was increased to fifty-two percent in 2005. *See* WILLIAM D. COHEN, HOUSE OF CARDS 297 (2009).

[217] *See* Charles E. Day, *Stripping Off Market Accountability: Housing Policy Perspectives on the Crisis in the Financial System*, 13 N. C. BANK. INSTIT., 105, 110-111 (2009)

[218] Gramm, *supra* note __.

[219] *Id.*

[220] BROOME & MARKHAM, REGULATION OF BANKING, *supra*, note __, at 412.

associated with the CRA. Community activist groups were demanding funding from banks as a condition for not protesting mergers on CRA grounds to bank regulators. Since mergers were the principal growth mechanism for large banks, many of them gave into this CRA "extortion."[221] These community groups also demanded allocations of loans to particular neighborhoods. The "CRA put a wad of power in the hands of community organizations to damage banks that they felt weren't doing enough for poor people. These community organizations became the dispensers of money for zero-down mortgages for poor people, again a lovely thing, but it didn't turn out so well."[222] Senator Gramm inserted a provision in the Gramm-Leach-Bliley Act in 1999 that required reports to be filed disclosing any CRA extortion payments, in the hope that disclosure would embarrass those groups and keep such demands to a minimum.[223]

Credit Default Swaps

The Glass-Steagall Act also proved to be no barrier to banks to enter the over-the-counter derivatives business. As a result of legislation passed in 1992, swaps were exempted from regulation under the Commodity Exchange Act of 1936.[224] Even before the enactment of that exemption, the swap had grown to a notional amount of some $4 trillion.[225] The top dealers in OTC derivatives in 1993 (six years before the repeal of Glass-Steagall) were commercial banks, including Chemical Bank, Citicorp, Bankers Trust, Société Générale, J.P. Morgan and the Union

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[221] Susan Sirota Gaetano, *An Overview of Financial Services Reform 1998*, 5 CONN. INS. L. J., 793, 808, N. 129 (
[222] COHEN, *supra* note __, at 297.
[223] Phil Gramm, *The New Banking Legislation: The Financial Modernization for the Twenty-First Century*, 53 SMU L. REV. 371, 373 (2000). *See also* Jonathan R. Macey & Geoffrey P. Miller, *The Community Reinvestment Act: An Economic Analysis*, 79 VA. L. REV. 291 (1993) (the CRA has done more harm than good).
[224] Futures Trading Practices Act of 1992, P.L. 102-546, 106 Stat. 3590. The Fed approved an application by J.P. Morgan & Co., Inc. in 1982 that allowed that bank to create a subsidiary that would register with the Commodity Futures Trading Commission as a futures commission merchant that could act as a broker in a number of commodity futures contracts. Jerry W. Markham & David J. Gilberg, *Federal Regulation of Bank Activities in the Commodities Markets*, 39 BUS. LAWYER 1719 (1984).
[225] Jerry W. Markham, *"Confederate Bonds," "General Custer," and the Regulation of Derivative Financial Instruments*, 25 SETON HALL L, REV. 1, 3, n. 8 (1994).

Bank of Switzerland. Some seventy percent of Bankers Trust's first quarter profits in 1994 came from derivative products. In total, commercial banks accounted for a notional amount of as much as $14 trillion in derivatives sales.[226]

The credit default swap was in place before the passage of GLBA. The OCC issued a bulletin in 1996 that set forth supervisory guidelines for a "new set of derivative products" in the form of "credit derivatives" that are "marketed as an efficient way to manage credit exposure.[227] One such instrument was the CDS, which the bulletin compared to a traditional standby letter of credit, and which would play a large role in the failure of the America International Group, Inc. during the subprime crisis.[228] The OCC bulletin opined that CDS could provide national banks with substantial benefits, such as allowing them to hedge concentration risks and credit deterioration of an asset and to adjust their credit profiles in a particular industry. The bulletin further noted the need for adequate supervisory procedures to guard against the several risks posed by CDS, including credit, liquidity, price, transaction and strategic risks.[229] The OCC was right to be concerned because ten years later those risks would manifest themselves in the subprime crisis. In the event, the OCC bulletin made clear that CDS were in wide use by banks at least three years before the repeal of Glass-Steagall by GLBA.

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[226] MARKHAM, VOL. III, *supra* note __, at 240.
[227] O.C.C. Bull. 96-43 at 1 (Aug. 12, 1996), *available at* http://www.occ.treas.gov/ftp/bulletin/96-43.doc.
[228] The OCC Bulletin described a CDS as follows:

> The risk hedger (i.e., buyer of credit protection) pays a fee, which effectively represents an option premium, in return for the right to receive a conditional payment if a specified "reference credit" defaults. A reference credit is simply the party whose credit performance will determine credit derivative cash flows. Typically, the reference credit has a borrowing relationship with the bank that is buying credit protection. The bank may diversify its portfolio by reducing its exposure to the borrower, and the swap enables it to do so without disturbing its relationship with the customer. The methods used to determine the amount of the payment that would be triggered by the default vary by instrument. In some contracts, the amount of the payment is agreed upon at the inception of the contract. In others, the amount paid is determined after the default event and is based upon the observed prices of similar debt obligations of the borrower in the corporate bond market. A default event typically must exceed a materiality threshold in order to trigger a payment under the swap contract.

Id. at 2.
[229] *Id*.

VI

What Caused the Subprime Crisis?

Excessive risk?

GLBA is going to be hard to finger as a culprit in the subprime crisis, so what really caused the crisis? The press and the federal government are blaming the subprime crisis on excessive risk taking by bank executives seeking large bonuses from compensation systems that were skewed toward encouraging excessive risk. However, significant amounts of commercial and investment bank subprime losses (and AIG's CDS losses) came from their exposure to the "Super-Senior," tranches of the subprime CDOS which, because of the CDO credit enhancement features, were often given triple-A ratings. Therefore, such instruments were by definition extremely low risk, and the banks had no reason to believe otherwise. Indeed, bank regulators in the United States allowed reduced, favorable capital treatment of Super Seniors when carried on bank balance sheets, provided that the Super Senior had a triple-A credit rating.[230] This regulatory blessing removed any concern of undue risk normally associated with subprime debt and the commercial banks loaded up the truck with these instruments.

For example, Merrill Lynch's U.S. CDO subprime net exposure consisted primarily of its Super Senior CDO portfolio.[231] Merrill Lynch wrote down $5.7 billion in 2008 due to its exposure to Super Senior CDOs.[232] This write-down was the result of two actions. On September 18, 2008, Merrill Lynch sold $30.6 billion gross notional amount of Super Senior CDOs to Lone

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[230] *See* GILLIAN TETT, FOOL'S GOLD 63-64 (2009) (hereinafter "FOOL'S GOLD").
[231] *See* MERRILL LYNCH, 2008 ANNUAL REPORT (Form 10-K) 27 (2008).
[232] *Id*. at 19-20.

Star Funds for $6.7 billion, which accounted for $4.4 billion of the write-down.[233] The reminder of the write-down was a result of Merrill Lynch "terminating certain hedges with monoline financial guarantors related to U.S. super senior ABS CDOs."[234]

Like Merrill Lynch, Citigroup's write-downs related to Super Senior CDOs came from its exposure to owning the instruments, as well as from losses related to its hedges with monoline financial guarantors for those instruments.[235] "As of September 30, 2007, Citigroup's Securities and Banking (S&B) held approximately $55 billion in U.S. subprime direct exposure, $43 billion of which was due to exposures in the most Super Senior tranches of CDOs."[236] Of Citigroup's $14.3 billion pre-tax loss (net of hedges) from subprime-related direct exposure, $12 billion was attributable to "net exposures to the super senior tranches of CDOs . . . derivatives on asset-backed securities or both."[237] Citigroup also "recorded pretax loss on $5.736 billion on its exposure to monoline insurers," the majority of which related to hedges on super senior

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[233] *Id.* at 19, 28.

[234] *Id.* Merrill Lynch sustained other massive losses in 2008, but most seem to be the result of adverse market conditions spawned by the subprime crisis. Merrill Lynch thus experienced "Net losses due to credit valuation adjustments ("CVA") related to certain hedges with financial guarantors of $10.4 billion." Since $1.3 billion was tied to super senior ABS CDO hedging, the remaining $9.1 billion of losses was related to other hedges. A total of $10.2 billion (excluding CVA) was written down on U.S. ABS CDOs, of which $5.8 billion was not related to super senior ABS CDO exposure. Another $10.8 billion written down was "related to other-than-temporary impairment charges recognized on our U.S. banks' investment securities portfolio, losses related to leveraged finance loans and commitments, losses related to certain government sponsored entities ("GSEs") and major U.S. broker-dealers, the default of a major U.S. broker-dealer and other market dislocations." In addition "net losses of $6.5 billion resulted primarily from write-downs and losses on asset sales across residential mortgage-related exposures and commercial real estate exposures." Finally, "net losses of $2.1 billion were due to write-downs on private equity investments"[234] There were other non-super senior ABS CDO related factors that drew down returns, including: additional dividends related to an mandatory exchange of convertible stock; a payment to Temasek Holdings of Singapore; a goodwill impairment related to the related to investment banking businesses; a fine and settlement related to auction rate securities; and a restructuring charge related to headcount reduction. *Id.* at18.

[235] *See* CITIGROUP, INC., 2008 ANNUAL REPORT (Form 10-K) 10 (2008).

[236] Kenneth C. Johnston, et al., *The Subprime Morass: Past Present and Future*, 12 N.C. BANK. INST. 125, 135 (2008).

[237] CITIGROUP, INC., 2008 ANNUAL REPORT, *supra*, note at 18.

positions.[238] UBS AG was another bank that was hard hit by Super Senior write-offs. Of its $18.7 billion in losses from U.S. subprime exposures, fifty percent were due to Super Seniors.[239]

AIG had no idea that it was incurring excessive risk in its Super Senior CDS. AIG assured investors in August 2007 that "it is hard for us, without being flippant, to even see a scenario within any kind of realm of reason that would see us losing $1 in any of those transactions."[240] AIG was weakened after it wrote off $11.12 billon on Super Senior CDS in the fourth quarter of 2007 and another $9.11 billion in the first quarter of 2008.[241] AIG noted that these were marked-to-market, unrealized losses due to fair value accounting and that it did not expect to have an actual material loss from these exposures.[242] AIG's CEO, Martin Sullivan also blamed mark-to-market accounting requirements for the losses sustained by AIGFP.[243] Sullivan complained that AIG was required to markdown its inventories even though it had no intention of selling them.[244] He may have had a point, as this was a common complaint in the industry.[245]

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[238] *Id.* Citigroup also had non-super senior ABS CDO related write-downs and losses that appear to relate to market conditions rather than reckless risk taking. Of the $14.1 billion in write-downs attributable to ABS CDO exposure, $1 billion was not related to super senior ABS CDOs. *Id.* at.68. Some of the monoline insurance exposure also was related to non-super senior ABS CDOs, but an exact amount was not quoted. *Id*. at 10 Furthermore, "due to the dislocation of the credit markets and the reduced market interest in higher-risk/higher-yield instruments since the latter half of 2007… Citigroup recorded pretax write-downs on funded and unfunded highly leveraged finance exposures of $4.9 billion in 2008." *Id*. at 71. Citigroup also sustained good will and wrote down intangible asset impairment charges worth $10.7 billion, primarily ($9.6 billion worth) due to the "overall weak industry outlook and continuing operating losses" *Id*. at 201. In addition, Citigroup had $1.8 billion in write-downs from lending and structuring exposures. Citigroup also posted $3.3 billion in losses related to structured investment vehicle (SIV) trading through November 18, 2008, as well as $2.6 billion worth of pre-tax losses, net of hedges, on commercial real estate exposure. Finally, an auction rate securities settlement added $926 million to Citigroup's 2008 losses. *Id.*

[239] UBS AG, SHAREHOLDER REPORT, *supra*, note – at §4.2.2.

[240] Robert O'Harrow, Jr. & Brady Dennis, *Credit Rating Downgrade, Real Estate Collapse Crippled AIG — 3rd of Three Parts*, L.A. TIMES, Jan. 2, 2009, *available at* http://articles.latimes.com/2009/jan/02/business/fi-aig2.

[241] AIG Reports First Quarter Results, http://ir.aigcorporate.com/phoenix.zhtml?c=76115&p=irol-newsArticle&ID=1142489&highlight=.

[242] AIG Issues Statement on Super Senior CDS Loss Risk, Feb.12, 2008, http://www.reuters.com/article/pressRelease /idUS151781+12-Feb-2008+BW20080212.

[243] AIG's risk model predicted that, based on historic default rates, the economy would have to fall into depression before AIG would experience losses from its CDS. *See* Robert O'Harrow Jr. & Brady Dennis, *Complex Deals Veiled Risk for AIG — 2nd of Three Parts*, L.A. TIMES, Jan. 1, 2009, *available at* http://articles.latimes.com/2009/jan/01/business/fi-aig1.

[244] *See* David Reilly, *Wave of Write-Offs Rattles Market --- Accounting Rules Blasted as Dow Falls; A $600 Billion Toll?* WALL ST. J., Mar. 1, 2008, at A1.

Indeed, at the end of the second quarter in 2009, AIG posted a $184 million unrealized market gain on its super senior CDS portfolio, due mainly to the substantial decline in outstanding net notional amount resulting from the termination of contracts in the fourth quarter of 2008, as well as to the narrowing of corporate credit spreads.[246]

AIG's most serious liquidity problem came from the collateral it had to post on its CDS portfolio on Super Senior CDOs. In July and August 2008, the continuing decline in value of the Super Senior CDO securities protected by AIGFP CDS, together with ratings downgrades of such CDO securities, resulted in AIGFP posting massive amounts of additional collateral.[247] "As of the end of August 2008, AIG had posted approximately $19.7 billion of collateral under its Super Senior CDS portfolio."[248] However, billions of dollars in collateral for CDS was flowing back into AIG in the second quarter of 2009 as the credit market began a recovery.[249]

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[245] It has been noted that :

> The foundational ideas associated with fair value accounting were adopted by FASB in Statement of Financial Accounting Standards (FAS) 115 [in 1993]. The rule divided financial assets into three categories—those held 'to maturity,' those held 'for trading purposes,' and those 'available for sale.' Each of these categories is treated slightly differently. Assets held to maturity are valued at amortized cost; assets held for trading are marked to market, with unrealized gains or losses included in earnings; and assets deemed available for sale are marked to market, with unrealized gains or losses excluded from earnings but included in shareholders' equity.

Peter J. Wallison, *Fair Value Accounting: A Critique*, FIN. SERVS. OUTLOOK (Am. Enterprise Inst. for Pub. Pol'y, Washington D.C.), July 2008, at 2. That concept was further advanced with FASB's SFAS 157, which was adopted in 2006, just as the subprime market peaked, and became effective for fiscal years beginning after November 15, 2007. SFAS 157 specified how fair value was to be reached, placing the most emphasis on the use of market prices when available. *Id.*

[246] *See* AMERICAN INTERNATIONAL GROUP, INC., QUARTERLY REPORT FOR THE PERIOD ENDING 30 JUNE, 2009 (Form 10-Q) 5 (2009).

[247] Am. Int'l Group, Inc., 2008 Annual Report (Form 10-K), p. 3.

[248] AIG also had $55.5 billion in net realized capital losses, which included the following: (1) sales of fixed maturities - $5.3 billion; (2) Other-than-temporary impairments, severity - $29.2 billion; (3) Other-than-temporary impairments, lack of intent to hold to recovery - $12.1 billion; (4) Other-than-temporary impairments, foreign currency declines - $1.9 billion; (5) Other-than-temporary impairments, issuer-specific credit events - $6 billion; (6) Other-than-temporary impairments, adverse projected cash flows on structured securities – $1.7 billion; and (7) Derivative instruments - $3.7 billion. These losses appear largely to be related to fair value accounting. *See* AMERICAN INTERNATIONAL GROUP, INC., 2009 QUARTERLY REPORT FOR THE PERIOD ENDING 30 JUNE, 2009 (Form 10-Q) 61, 67 (2009).

[249] *See* Liam Plevin, *In Reversal of Fortune, AIG Recoups Collateral*, WALL ST. J., Oct. 30, 2009, at A25.

Fair value pricing resulted in a pro-cyclical progression of write-downs that bore no relation to actual value.[250] "The difficulty in putting a value on loans, securities, and exotic financial instruments banks were carrying on their books became one of the most debilitating features of the Great Panic" in 2008.[251] Critics of fair value accounting charged that, because liquidity in subprime investments had dried up as the subprime crisis blossomed, the only prices available for "fair value" accounting were fire sale prices from desperate sellers. Those prices in no way reflected the actual value of the Super Seniors as measured by their cash flows or defaults. One accountant complained to the FASB that: "May the souls of those who developed FASB 157 burn in the seventh circle of Dante's Hell."[252] Warren Buffett likened mark-to-market requirements for measuring bank regulatory capital to throwing "gasoline on the fire in terms of financial institutions."[253]

Interest Rates

Interest rate policies also bear scrutiny as a precipitating factor in the subprime crisis. The ten-year bull market that preceded the stock market crash in 2000 was an era of high expectations as stock market indexes exploded in value, reaching heights undreamed of in earlier years. The Dow Jones Industrial Average doubled and then doubled again during that bull

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[250] *Id.*
[251] WESSEL, *supra* note __, at 128.
[252] *Accounting Principles*, 40 SEC. REG. & L. REP. (BNA) 1767 (Oct. 27, 2008).
[253] Holman W. Jenkins, Jr., *Buffett's Unmentionable Bank Solution*, WALL ST. J., Mar. 11, 2 *See* AMERICAN INTERNATIONAL GROUP, INC., 2009 QUARTERLY REPORT FOR THE PERIOD ENDING 30 JUNE, 2009 (Form 10-Q) 61, 67 (2009).009, at A13. As one author noted:

> The argument against fair value is a compelling one: volatile markets make securities valuation difficult and undermine investors' confidence, forcing companies to mark down values, leading to greater illiquidity and further markdowns. The more the markdowns impair capital, the greater the loss of investor confidence, and the faster the churn of the self-reinforcing cycle.

Todd Davenport. *Fair Value: Few Fans, But Fewer Alternatives; Despite Widespread Frustration, Changes Don't Seem Likely*, 173 AM. BANKER 1 (Mar. 24, 2008).

market, reaching a height of 11722 on January 14, 2000.[254] Spurred by the growth of the high-tech "dot.com" companies that had exploited the Internet in numerous innovative ways, the stock market bubble in the 1990s was said to be the result of "irrational exuberance" by Alan Greenspan, the then Federal Reserve Board Chairman. It was also attributed to low interest rates encouraged by the Fed. [255]

Greenspan single-handedly broke the dot.com bubble through a series of punitive interest rate increases. Trillions of dollars in stock values evaporated in the ensuing downturn.[256] The Fed's actions also helped push the country into a near recession that greeted the newly inaugurated forty-third President of the United States, George W. Bush. Although the Fed reversed course and started slashing interest rates in January 2001, that action was too little and too late to prevent a downturn. [257]

The fed funds rate was 6.51 percent in November 2000.[258] It dropped to nearly one percent in July 2003. [259] This triggered a housing mania in the United States. In order to crush the real estate bubble that fed on those low rates, Fed Chairman Alan Greenspan began a series of seventeen consecutive interest rate increases beginning on June 30, 2004.[260] Ben Bernanke, who replaced Alan Greenspan as the Chairman of the Federal Reserve Board in a peaceful transfer of power on February 1, 2006, picked up the cudgel and continued Greenspan's efforts with still

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[254] Greg Ip, *Greenspan Issues Hopeful Outlook As Stocks Sink --- But He Warns Loss of Trust Caused by `Infectious Greed' Could Undercut Recovery*, WALL ST. J., July 17, 2002, at A1.

[255] E.S. Browning, Greg Ip and Leslie Scism, *What Correction? With Dazzling Speed, Market Roars Back To Another New High --- Surge Puts the Dow at 9374 In a Lightning Reversal Of Autumn's Doldrums --- `Nothing to Get in Its Way*,' WALL ST. J., Nov. 24, 1998, at A1.

[256] David Wessel, *Capital: Great Expectations And Greenspan*, WALL ST. J., March 22, 2001, at A1.

[257] Greg Ip and Jacob M. Schlesinger, *Economic Fix: As Fed Trims Rates, Other Forces Work To Dilute the Benefits --- Consumer Debt, Slow Exports And Corporate Jitters Damp Jump-Start Bid --- Markets Lose More Ground*, WALL ST. J., March 21, 2001, at A1.

[258] E.S. Browning, *Stocks Fall Back Before Meeting Of Fed on Rates*, WALL ST. J., Dec. 11, 2001, at C1.

[259] David Wessel, *The Economy -- Capital: Deflation Spurs Fed to Talk More, but With No Uptick in Clarity*, WALL ST. J., July 31, 2003, at A2.

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

more interest rate increases.[261] The effects of those actions were already manifesting themselves as Bernanke assumed office. Indeed, the housing market experienced the largest decline in new home sales in over ten years in the months after Bernanke became the Fed Chairman.[262]

Undeterred by that rather ominous news, Bernanke imposed another rate increase on March 28, 2006.[263] This was the fifteenth straight interest rate increase, and Bernanke suggested more rate increases would be forthcoming. He proved true to his word with a sixteenth straight rate increase on May 10, 2006, pushing short-term rates to five percent.[264] The seventeenth consecutive increase came on June 29, 2006, increasing short-term rates to 5.25 percent.[265] The effect of this onslaught on the real estate market turned into a financial crisis in 2007. Home sales and new residential construction slowed dramatically, and the market became glutted with unsold homes.[266]

The Fed then began slashing rates once again, pushing short-term rates to near zero.[267] This raises the question of whether another bubble is being formed in one asset class or another that will have to be broken in the future with devastating effects on the economy. In the off-season, the Fed focuses on inflation and has grand debates over "targeted" inflation rates and other approaches to taming inflation. Those debates and policies dominate Fed thinking until there is an economic crisis that causes concerns over inflation to be abandoned, but not until much damage has been done to the economy. This approach is wrong-headed, and must be corrected by adding more certainty to the process in order to allow better business and economic

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[261] ETHAN S. HARRIS, BEN BERNANKE'S FED 32 (2008).
[262] Paul Krugman, Coming Down To Earth, N.Y. TIMES, May 19, 2006, at A25.
[263] Greg Ip, *Fed Raises Rates By 1/4 Point, Hints More May Come --- Bernanke's Debut Statement Shows New Transparency; Stocks Fall, Bond Yields Rise*, WALL ST. J., March 29, 2006.
[264] HARRIS, *supra*, note at 176.
[265] *Shares Close Mixed*, *supra*, note .
[266] Jack Healy, *October Report Shows Home Prices Down 18% From Last Year*, N.Y. TIMES, Dec. 31, 2008 at B3.
[267] Edmund L. Andrews, *Fed's Minutes Reveal Shock at Downturn*, N.Y. TIMES, Jan. 7, 2009, at B1.

planning. The Fed needs to adopt a targeted rate of interest, which it can lower or raise gradually, according to a prescribed formula, as inflation or other economic conditions dictate, but always with a view to returning to the equilibrium interest rate target. This will allow businesses to plan for increased, or decreased, interest rates without having to read the tea leafs to determine what the Fed will do in any given circumstance.

The Fed certainly has a role to play in fighting inflation, as proved by Paul Volcker in the 1980s, but more certainty could be added by indexing the interest rate to the rate of core inflation. This would, once again, allow more flexible financial planning when inflation is on the rise. This is not a new idea. John Taylor, a Stanford economics professor, posited the "Taylor Rule," which created a formula for "setting interest rates that depended on where inflation was versus the Fed's goal for it, how far from full employment the economy was and what the short term rate should be when the economy was perking along."[268]

Any interest rate changes should be measured and slow. The effects of interest rate changes are not visible for some months, which induced the Fed to adopt a series of rapid interest rate changes in order to obtain a more rapid result, but it overplayed its hand in taking that approach. Inevitably, too much is done, with the effect of crashing the economy or setting off a bubble. As of this writing, the Fed Fund target rate is near zero, and only the vaguest of suggestions has been given out by the Fed on its future rate policy. The only guidance provided by the Fed was that rates would stay low for an "extended period," which means at least six months.[269] However, a Fed governor, Kevin Warsh, stated, in September 2009, that when the Fed does decide to increase rates it would do it "with greater swiftness" than it has in the past,

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[268] WESSEL, *supra*, note at 122.
[269] Krishna Guha & Michael Mackenzie, *Fed Sees Six More Months of Low Rates*, FIN. TIMES (London), Nov. 5, 2009, at 1; Kevin M. Warsh, *The Fed's Job Is Only Half Over*, WALL ST. J., Sept. 25, 2009, at A15.

indicating that the Fed has learned nothing from observing the effects of its roller coaster rate changes.[270]

Business Judgment Failures

The regulated banks, rating agencies and the "shadow" banking world of subprime non-banks and mortgage brokers must also bear some responsibility for the subprime crisis. However, those failures cannot be tied to GLBA. The "no-doc," "low-doc," stated income ("liar loans") and "Ninja" (no income, no job, no assets) and "teaser" rate loans were sometimes irresponsibility underwritten on the belief that an ever-rising housing market would allow refinancings and avoid foreclosure.[271] That belief proved faulty in the downturn. The larger banks failed in their due diligence in the creditworthiness of the subprime borrowers. There seemed to be a marked decline in subprime credit quality as the crisis approached. Mortgage lending to only creditworthy customers is a bank function that Glass-Steagall did not address.

Risk assessment models failed to predict the subprime crisis. A risk model developed by David Li, the Gaussian Copula correlation model, did for collateralized debt obligations (CDOs) what the Black-Scholes model did for options.[272] Seemingly, it allowed a precise mathematical computation of the risks posed by these instruments. In fact, the Gaussian Copula models were simply not designed to forecast such an event. The Basel II accord for bank capital also allowed the use of Value-at-Risk ("VAR") models for commercial bank risk assessment,[273] but they were based on bell curve assessments that did not recognize the outliers, the "Black Swan" unpredictable events. The rating agencies suffered the same flaw in the models they used for

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[270] Jon Hilsenrath, "Fed Official Sees Faster Rate Increases in Future," WALL ST. J., Sept. 26-27, 2009, at A2.
[271] *See* CHAIN OF BLAME, *supra*, note (describing these abuses).
[272] FOOL'S GOLD, *supra*, note at 101-102.
[273]*See Generally,* Elene Spanakos, *Harmonization of International Adequacy Rules for Securities Firms: An Argument to Implement the Value at Risk Approach by Adopting Basil's Internal Model Methodology*, 26 BKYLN. J. INT'L. L. 221 (2000) (discussing the role of VAR).

granting Triple-A status to the Super Seniors. The rating agencies used risk models for awarding the triple-A rating that did not take into account the possibility of a major downturn in the real estate market.[274]

VII

Conclusion

The claim that the removal of the dividing line between commercial and investment banking activities laid the groundwork for the subprime crisis does not seem to be supported by the record. Commercial banks were forced into subprime lending by the Community Reinvestment Act of 1977, and they were encouraged by the government to securitize those mortgages before the enactment of GLBA. Government-housing policies, artificially low interest rates, misapplications of fair value accounting standards, defective risk models, and sheer greed and ineptitude by mortgage lenders and brokers appear to be the real culprits in the subprime crisis, not the right honourable Messers Gramm, Leach and Bliley.

[274] For a lively discussion of those flaws see NASSIM NICHOLAS TALEB, THE BLACK SWAN (2007).