REVISITING THE CAUSES OF THE FINANCIAL CRISIS

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ABSTRACT

Much has been written on the legal causes of the financial crisis and its aftermath, often referred to as the Great Recession. Presumably the debate will continue for many years to come, much as scholars continue to debate the causes of the Great Depression. Lost, however, in the descriptions of arcane laws and complex derivative financial products, is a relatively brief and straightforward account of the crisis and its most likely causes for interested lawyers, law students, or graduate students who are not specialists and do not want to become specialists. This Essay, based on a presentation at the Indiana Law Review’s 2013 Symposium, Law and the Financial Crisis, aims to provide such an overview.

INTRODUCTION

Not surprisingly, an enormous amount has been written on the causes of the financial crisis from both academics1 and others.2 Even the federal government’s

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2. Journalists on the financial crisis include: JOHN CASSIDY, HOW MARKETS FAIL: THE LOGIC OF ECONOMIC CALAMITIES (2009); WILLIAM D. COHAN, HOUSE OF CARDS: A TALE OF HUBRIS AND WRETCHED EXCESS ON WALL STREET (2009); GREG FARRELL, CRASH OF THE TITANS:
principle analysis of the crisis has become a best seller. Most of these publications, however, focus heavily on single causes, have political axes to grind, concentrate on personalities rather than policies, were published before enough of the facts became well-known, or assume a high-level of background knowledge and expertise. There is far less available material for educated and interested—but non-specialist—lawyers, law students, or graduate students that succinctly analyzes and explains potential causal legal factors. This short essay attempts to provide this analysis and explanation.

At one level, the financial crisis was just like many others in U.S. history. Too many creditors simultaneously sought the return of their assets. Two words, “bank run,” get to the core of the financial crisis. At another level, however, what made this crisis different was the focus on the “shadow banking system”—institutions and transactions outside the regular banking system.


4. My aim here is simply to provide a general high-level overview, so in some places I will include some simplifications or oversimplifications.

5. Gary Gorton, Banking Must Not Be Left in the Shadows, FIN. TIMES (Nov. 20, 2012), http://www.ft.com/intl/cms/s/0/48b78190-3278-11e2-916a-00144feabdc0.html#axzz2aSPoQWIQ (claiming that “[t]he financial crisis again showed that in market economies bank runs recur, over and over”).


7. See Gorton, supra note 1, at 13-60. The Financial Stability Board’s task force defined “shadow banking” as “credit intermediation involving entities and activities outside the regular banking system.” Kelly Evans, Bank-Run Risk in the Shadows, WALL ST. J., Dec. 5, 2011, http://online.wsj.com/article/SB10001424052970204397704577074782946096256.html. Credit is intermediated “through a wide range of securitization and secured funding techniques.” Zoltan
Meanwhile the general public did not understand or even notice these institutions and transactions. Notwithstanding the lack of attention, shadow banking had quietly become enormous.8

Most agree a credit crunch precipitated the crisis. A credit crunch occurs when enough parties simply refuse to lend to each other.9 Overinvestment in housing led to a real estate bubble,10 and this bubble’s bursting created a domino effect, beginning with greatly increased defaults on subprime mortgages. The defaults were greatly amplified by collateralized debt obligations, credit default swaps, and other complex derivatives. Losses on these securities resulted initially in the fire sale of a big investment bank, Bear Stearns, and a few months later, a full blown banking crisis leading to the biggest bankruptcy in U.S. history, Lehman Brothers, and the collapse of several other financial giants.11 The effect of the collapse spread around the world, leading to what is referred to as the Great Recession, which, in the view of many, continues to this day.12

There is far less agreement on the causes of this chain reaction. Nobel laureate economist Joseph Stiglitz attributed the crisis to “system failure,” which is when not just a single decision, but a cascade of decisions, produces a tragic result.13 Judge Richard Posner seems to blame the crisis on capitalism itself.14

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8. Pozsar et al., *Shadow Banking*, Federal Reserve Bank of New York Staff Rep. No. 458 (July 2010, Rev. Feb. 2012), http://www.ny.frb.org/research/staff_reports/sr458.pdf, archived at http://perma.cc/RE2K-TFEL (defining shadow banks as “financial intermediaries that conduct maturity, credit, and liquidity transformation without explicit access to central bank liquidity or public sector credit guarantees”). They add, “what distinguishes shadow banks from traditional banks is their lack of access to public sources of liquidity such as the Federal Reserve’s discount window, or public sources of insurance such as Federal Deposit Insurance.” Id. at 2.


11. See FCIC REPORT, supra note 3, at 354-62 (2011) (explaining the bankruptcy of Lehman Brothers following the burst of the real estate bubble).


Others argue that it was private sector greed, pure and simple. Washington Post columnist Robert Samuelson favors a “narrative rooted in mass and bipartisan delusion,” what he refers to as a “long boom-bust” explanation. He claims that “[w]hat ultimately explains the financial crisis and Great Recession is an old-fashioned boom and bust, of which the housing collapse was merely a part,” where the boom lasted from 1983-2007. Joe Nocera seems to agree, claiming that an analysis requires the skills of a psychologist, as it resulted from a “mass delusion” about housing prices, and is a “part of the human condition.” Purported causes still make headlines, including a recent article asserting that cocaine use caused the crisis.

This essay will briefly describe the crisis (what happened?) and then analyze various proposed causes (why it happened?). First, however, a disclaimer: while there is general agreement over what the crisis was, the causes remain contested and arguably unclear. Moreover, although we now have the first drafts of appointing Alan Greenspan, an “anti-regulator” to serve as an “enforcer,” and repealing the Glass Steagall Act.


15. Steve Denning, Lest We Forget: Why We Had a Financial Crisis, FORBES (Nov. 11, 2011), http://www.forbes.com/sites/stevedenning/2011/11/22/5086/, archived at http://perma.cc/K3RP-NZM6 (“It is clear to anyone who has studied the financial crisis of 2008 that the private sector’s drive for short-term profit was behind it.”).


17. Id. More conventional explanations, he claims, result from other motivations. Id.


history, the second drafts are only just appearing, and there will undoubtedly be third and fourth drafts as well.22

I. THE CRISIS: EVENTS

What do we really know about the financial crisis? Although it has been described as a “long and complicated story,”23 at a high enough level of generality nearly everyone agrees. Risk, largely unobserved and linked to sub-prime mortgages and derivative securities that were based on them, built up in the financial system.24 As the risks (and resultant losses) became apparent with the bursting of the housing bubble, concerns grew over borrowers’ solvency. Lenders withdrew from the short-term debt market, resulting in a liquidity crisis, not just for the financial economy, but for what is sometimes referred to as the “real economy” as well.25 Some financial institutions, notably Lehman Brothers, failed, whereas others were effectively taken over by governmental26 or other institutions in shotgun marriages brokered by the government.27 The U.S. government and others took unprecedented and decisive actions, and disaster—the risk of not having an economy within a few days28—was narrowly

Bernanke has a somewhat different view: “[b]ecause the crisis was so complex, its lessons are many, and they are not always straightforward.” Ben S. Bernanke, Monetary Policy and the Housing Bubble, Speech at the Annual Meeting of the Am. Econ. Ass’n (Jan. 3, 2010), http://www.federalreserve.gov/newsevents/speech/bernanke20100103a.htm, archived at http://perma.cc/5FNA-S3G3.

22. See Blinder, supra note 1, at 5 (claiming that his book, published in January 2013, should be considered a “second draft of history”).

23. Id.

24. Michael Lewis describes some of those who observed and greatly profited from recognizing the buildup of risk. See generally Lewis, supra note 2 (focusing on hedge fund managers, traders and analysts who invested against subprime mortgages well before the crisis).

25. The “real economy” can be defined as “the part of the economy that is concerned with actually producing goods and services, as opposed to the part of the economy that is concerned with buying and selling on the financial markets.” Fin. Times Lexicon, http://lexicon.ft.com/Term?term=real-economy archived at http://perma.cc/Z8T7-FBCJ (last visited Oct. 1, 2013).


27. Id. (noting that Bank of America bought Merrill Lynch, Citigroup and then Wells Fargo bought Wachovia and JP Morgan Chase bought part of Washington Mutual.).

28. On Thursday, September 18, Federal Reserve Chairman Ben Bernanke told Congress that if the largest banks were not saved “we may not have an economy on Monday.” Andrew Ross Sorkin et al., As Credit Crisis Spiraled, Alarm Led to Action, N.Y. Times, Oct. 1, 2008, http://www.nytimes.com/2008/10/02/business/02crisis.html?pagewanted=all&_r=0, archived at http://perma.cc/VY8J-LS9N. As Ben Bernanke said later “[w]e came very, very close to a global financial meltdown.” Blinder, supra note 1, at 3.
Even so, millions of people lost their homes, jobs, and much of their savings, among other harms.

These external contours of the crisis are well known, even if the reasons behind them are less well understood. Housing prices peaked in 2006 leading to early harbingers of the crisis. In April 2007, New Century Financial Corporation, a company that had specialized in loans to people with poor credit who were now defaulting in overwhelming numbers, declared bankruptcy. Another warning came in July 2007 with the collapse of two Bear Stearns hedge funds capitalized at $1.6 billion dollars, due to their investment in collateralized debt obligations backed by subprime mortgage loans. In March 2008, there was the government-brokered and supported—$30 billion in guarantees—forced-sale of Bear Stearns to JP Morgan Chase, at a final price of $10 per share, less than 10% of the stock’s 52 week high. On September 7, Fannie Mae and Freddie Mac, the government sponsored entities (GSEs) that owned or guaranteed roughly $6 trillion in U.S. mortgages, were put in conservatorship. Eight days later, after a round the

29. Sorkin et al., supra note 28.
31. See, e.g., Blinder, supra note 1, at 12 (providing a graph showing declining employment after the crisis).
33. This account is similar to that presented by the FCIC report. FCIC REPORT, supra note 3, at 233-388. The FCIC report adds that the collapse was a global phenomenon, as investors around the world had exposure to U.S. mortgages through securities and derivative securities.
38. Mark Jickling, Fannie Mae and Freddie Mac in Conservatorship 1 (2008), available at
clock rescue effort failed, Lehman Brothers Holding Inc., the fourth largest U.S. investment bank, filed for the largest ever bankruptcy.\textsuperscript{39} The next day, AIG (the world’s largest insurance company), on the hook for $441 billion in credit default swaps, was rescued by the U.S. Federal Reserve Bank.\textsuperscript{40} 

The bailout and other efforts, however, failed to end the crisis.\textsuperscript{41} Investors panicked all over the world, trying to flee risky assets and not knowing what financial institutions were really at risk.\textsuperscript{42} Nearly every asset class declined in value, except for U.S. government treasury obligations.\textsuperscript{43} Over the next few weeks, more giant financial institutions were targeted (Morgan Stanley), others failed (Washington Mutual) or were purchased (Wachovia), and stock prices gyrated wildly.\textsuperscript{44} The crisis also spread rapidly around the world, with the bailing-out or seizure of at least five European banks.\textsuperscript{45} These events led President Bush to ask of Treasury Secretary Paulson: “How did we get here?”\textsuperscript{46} Clearly, the impact of the well-known decline in housing prices had been grossly underestimated. Early on, in July 2007, Federal Reserve Chairman Bernanke informed the U.S. Senate’s Banking Committee that losses of up to $100 billion due to subprime mortgage\textsuperscript{47} products were possible.\textsuperscript{48} The U.S. stock indices, the Dow Jones Industrial Average, and the Standard & Poor’s 500 each


\textsuperscript{40} \textit{Lewis, supra} note 2, at 237.

\textsuperscript{41} \textit{Id.}

\textsuperscript{42} \textit{Id.} at 238.

\textsuperscript{43} \textit{Id.}

\textsuperscript{44} \textit{Id.} at 240.

\textsuperscript{45} Mark Landler, \textit{The U.S. Financial Crisis is Spreading to Europe}, N.Y. TIMES, Sept. 30, 1998, http://www.nytimes.com/2008/10/01/business/worldbusiness/01global.html_r=0 (quoting a European economist stating that “a bank run spreads around the world, not around the block”).


\textsuperscript{47} “Subprime” is the term used for borrowers who were not eligible for (or sometimes were steered away from) mortgages at the “prime” rate. Such borrowers had lower credit ratings and thus were deemed to be less likely to repay their loans than the safest borrowers. To compensate lenders for the increased credit risk they charged a higher interest rate. Interestingly, (within the last twenty years), the term subprime had been used instead to refer to an interest rate that was below the prime rate, and thus only available to the highest-quality borrowers.

hit all-time peaks in the fall of 2007 (a peak which was only passed in 2013).49 And in what certainly with hindsight justifies being called “simply the worst deal in the history of the financial services industry,”50 in January 2008, Bank of America agreed to buy Countrywide Financial, one of the most aggressive providers of subprime mortgages, for $4.1 billion.51 At the time, however, some still believed it was a good deal.52

Beyond this barebones factual outline, there is much disagreement, not just among pundits, but among economists and policy analysts too.53 To explain the financial collapse, consider how financial institutions are structured. Each has capital to keep it stable and earn profits from products such as loans, including mortgages.54 The more capital a financial institution has relative to its loans, generally the more stable the financial institution. Making more and riskier loans with insufficient capital can result in the failure of the financial institution.

In the years leading up to September 2008, many of the financial institutions had not only issued and securitized mortgages, but also bought securities backed by the mortgages.55 These were mortgage-backed securities (MBSs). They also bought collateralized debt obligations (CDOs), securities backed by the MBSs, which were one step further removed from the mortgages.56 And one step even further along were synthetic CDOs, the value of which were based essentially on credit default swaps, which were a kind of insurance against other securities defaulting.57

Why did so many financial institutions buy so many of these securities?

51. Id.
52. Id. Bank of America has reportedly spent $40 billion to resolve litigation. Id. It has reportedly threatened to put Countrywide Financial into bankruptcy if various settlements in the works are not finalized. Matt Egan, Could BofA Still Toss Countrywide into Bankruptcy?, FOX BUS. (June 11, 2013), http://www.foxbusiness.com/industries/2013/06/11/could-bofa-still-toss-countrywide-into-bankruptcy/ archived at http://perma.cc/6W24-E2JX.
54. Bank capital can perhaps best be analogized to the down payment on a house. See Matthew Yglesias, What is Bank Capital? It’s Not Reserves, It’s Not a Cushion, and You Don’t Hold It, SLATE (July 10, 2013), http://www.slate.com/blogs/moneybox/2013/07/10/bank_capital_requirements_not_reserves_not_held.html archived at http://perma.cc/T9T3-2TW5. It can thus magnify both returns and losses.
55. See FCIC REPORT, supra note 3, at 256 (2011).
56. Id.
57. Id. at 236.
(Remember, for every security sold there also had to be a buyer.) For one reason, buyers often thought they were good deals, in the sense of a given return for the perceived risk.58 Also, because of the triple A ratings many of these securities received from the ratings agencies, for some institutions they could be treated more favorably as capital,59 and for others only such high rated securities were permissible investments.60 Moreover, these securities were often seen as facilitating diversification, which would be good for the financial institution.61

Although it seems obvious now, all of these securities depended on the value of the underlying securities, which ultimately went back to the mortgages themselves—mainly subprime mortgages. When the underlying securities declined (home buyers defaulting on their mortgages, resulting in some MBSs, CDOs and synthetics losing value) the financial institutions must write down the value of the assets, thereby reducing their capital.62

Consider Lehman Brothers. Investment banks like Lehman Brothers typically rely on short-term funding.63 Lehman was in fact “rolling over” $100 billion in short term financing every month, meaning that if it could not find lenders each month willing to lend them that much, it would be at risk of insolvency.64 But with concerns regarding its stability (and in particular whether its capital remains sufficiently valuable) nobody will risk lending it money. Lehman is going to fail. The weekend before the September 15th, 2008 bankruptcy filing, the company was desperately looking for help.65 Barclays and Bank of America, despite pressure from the federal government, would not buy Lehman (which would have required the buyers to guarantee their debts), so Lehman collapses.66 This is terrible news, particularly for Lehman’s creditors and

58. Id. at 242. As Mclean and Nocera put it, buyers were “buying a [triple-A] rating and thought [they] couldn’t lose money.” MCLEAN & NOCERA, supra note 2 at 266.
60. Id. at 8.
61. Id. at 55.
62. In House of Cards: A Tale of Hubris and Wretched Excess on Wall Street, William D. Cohan describes how a sharp decline in the reference value of mortgage securities led to the demise of the Bear Stearns’ mortgage funds. Specifically, Goldman Sachs provided a value that dropped 43% in one month, resulting in a drop in the funds’ asset values of 13%, and a restated earning release. See COHAN, supra note 2, at 399-402.
66. Id.
employees, but this is one of the side effects of free-market capitalism.

However, these financial institutions are far from independent. It is as if they are all roped together. When a large institution like Lehman sinks, others become increasingly unstable and may actually be brought under as well. Globally, financial institutions were firmly and comprehensively intertwined—webbed together through their contractual obligations.67 When Lehman goes down, some of its debt holders are not going to get paid, causing losses for them. Other debt-holders, however, have insured their debt—through credit default swaps—which means the counterparties, the sellers, companies like AIG, are on the hook.68

One very important way these institutions are roped together is through CDSs.69 Credit default swaps are guarantees or insurance policies, like home insurance.70 You buy home insurance to protect your asset—if your house burns, the insurance company makes you whole. You have thus swapped the financial risk of your house being destroyed with the insurance company (in exchange for your premium payments). Likewise, with credit default swaps, one company swaps with another the risk of the borrower defaulting in exchange for a premium.71 As part of this transaction, the company might be concerned that the issuer of the CDS might in turn default, so frequently the company would request collateral—collateral that might need to be supplemented.72 An interesting feature of this is that a CDS can be very beneficial, much as buying home insurance reduces risk for homeowners.73 But CDSs go one step further. They can act as though you bought home insurance on somebody else’s house.74 Instead of reducing risk, it is more like a bet. Financial institutions would buy CDSs on debt they did not hold.75 In essence, they were predicting (hoping?) that the chance of default outweighed the premiums. At a minimum, the institutions

67. Id.
68. AIG was of course on the hook for far more than just some of Lehman’s obligations. They had also insured some of those securities, $57 billion worth, which were dependent on sub-prime mortgages.
69. Another way institutions were intertwined was through “cross buying.” According to the SEC, “heading into 2007, there was a Streetwide gentleman’s agreement: You buy my BBB tranches [low rated securities] and I’ll buy yours.” FCIC REPORT, supra note 3, at 203.
72. FCIC REPORT, supra note 3, at 50.
73. Id.
74. Id.
75. Id.
would also have an incentive not to help the borrower survive. By 2008, the value of CDSs greatly outweighed the underlying securities in valuation. Therefore, when Lehman defaulted on its bonds, not only were bond-holders at risk, but also any institution that had issued CDSs on Lehman’s bonds.

This interconnected web of roped-together institutions was at great risk of collapse. Those institutions with more conservative financial structures, i.e., higher relative amounts of capital, or those who did not keep high values of MBSs and CDOs were somewhat safer, but the combined impact put nearly everyone at risk. All of the other institutions were desperately trying to untie the ropes that they had, not just with Lehman, but with the other less stable institutions as well. The problem was, in part, asymmetric information, or what Nobel Prize winner George Akerlof called the “lemon problem.” None of the institutions could tell which were the good, solid institutions, and which were not, in part because of the difficulty in valuing an illiquid security that represents a little piece of perhaps 1000 to 10,000 mortgages. Thus, the institutions kept all high-quality liquid instruments, like cash and treasury bills, and nobody was willing to buy, or lend money based on, the mortgage-linked securities that had been exposed as risky.

So, the financial institutions were trying to undo or reduce their ties to the other financial institutions. But everyone was doing the same thing at the same time and some were getting ever closer to failure. With the announcement of Merrill Lynch’s sale to Bank of America, and Lehman’s bankruptcy filing, AIG was expected to be next. These circumstances forced the government to rescue AIG the following day. Over the next few weeks, Washington Mutual was

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76. Id.
77. Id. at 17.
78. See id. at 27 (discussing the interconnectivity of financial firms and its contribution to the financial crisis).
79. See George A. Akerlof, The Market for “Lemons”: Quality Uncertainty and the Market Mechanism, 84 Q.J. ECON. 488, 490 (1970) (discussing used car purchasers’ reasonable fear that the car they are buying is a lemon because sellers know more about the car and are more likely to sell it if it is a lemon); see also Antony Page, Taking Stock of the First Amendment’s Application to Securities Regulation, 58 S.C. LAW REV. 789, 814-16 (2007) (analogizing the used car “lemon problem” with securities).
80. See id. (discussing why asymmetrical information would discourage firms from purchasing risky securities).
81. Some have wondered why Bank of America paid $29 per share for Merrill Lynch when it appears highly probable the bank could have paid substantially less. See, e.g., Lewis Gets Faint Praise From Buffet, N.Y. TIMES, Sept. 16, 2009 (quoting noted investor Warren Buffet asking “Why pay X for Merrill on Sunday when you could have had it for pennies on Monday?).
about to fail and Federal regulators seized and sold it within hours.84 Wachovia was in a similar state, and ended up being bought by Wells Fargo.85

Congress passed the rescue plan, the Emergency Economic Stabilization Act of 2008 (EESA), on October 3.86 The EESA was originally designed to solve the problem of financial institutions owning too much risky or hard to value capital.87 The government would buy the securities, the MBSs, CDOs, and their offshoots that nobody else wanted.88 As financial institutions sold these toxic assets, their cash positions (capital) would increase, thereby making them more stable.89 However, it quickly became clear that this response was inadequate.90 Some institutions still lacked equity.91 To address this issue, the United States Department of the Treasury (“Treasury”) diverted some of the bailout funds, directly shoring capital.92 The Treasury compelled the nine largest banks to sell equity, even the ones that did not want to,93 using a total of $250 billion to this end.94

Citigroup went back to the well in late November, receiving a $20 billion capital infusion from the Treasury and guarantees of $306 billion in assets, which was described as an “undisguised gift.”95 In mid-January, 2009, Bank of America also received $20 billion and guarantees of $118 billion.96

85. See FCIC REPORT, supra note 3, at 368-69.
87. Id.
89. Id.
92. Id.
93. Id. Why force all of the big financial institutions to take the investment? This prevented line-drawing between the “good” and “bad” banks. Id.
94. Id.
Overall, the Federal Reserve lent more than $1.2 trillion in 2008 in emergency loans to support financial institutions.\textsuperscript{97} It ended up committing $7.77 trillion dollars by March 2009 to keep the financial system, and world economy, functioning.\textsuperscript{98}

II. THE CRISIS: CAUSES

There are two main schools of thought regarding the causes of the financial crisis. One, from the right, asserts that government policies encouraging homeownership—particularly to lower income and minority buyers--led to the relaxation of underwriting standards, the housing bubble, and then ultimately its collapse.\textsuperscript{99} The other, from the left, attributes the crisis to the private sector that took too many risks while the government failed to regulate, or even understand, derivative financial products and big financial institutions.\textsuperscript{100} The first narrative claims the government did too much, whereas the second claims the government did not do enough.\textsuperscript{101} The related claim is regarding “free” markets: they either would have worked to prevent the crisis but were not permitted to do so, or they themselves created the crisis and should not have been permitted to do so. Perhaps it is underappreciated that these two narratives are not necessarily inconsistent. Both could be at fault—government regulation could have encouraged the crisis and under-regulation could have failed to prevent it.

The causes of the crisis are something of a Rorschach test; experts can see in the causes what they want to see.\textsuperscript{102} Better yet, perhaps the causes are like a thaumatrope; the image depends on which side of a card one looks, but when the toy is in motion, the images on both sides are combined.\textsuperscript{103} The real question over the legal causes of the financial crisis, as Mark Calabria of the Cato Institute asserted, “is the quality and substance of [the] regulation” at issue.\textsuperscript{104}

\begin{itemize}
\item \textsuperscript{98} Id.
\item \textsuperscript{99} See FCIC REPORT, supra note 3, at 444.
\item \textsuperscript{101} Id.
\item \textsuperscript{102} Judge Richard Posner emphasizes this notion when he refers to ideology having led to blindness in the economics profession. See POSNER, supra note 14, at 328.
\item \textsuperscript{103} Chopsticks78, Thaumatrope: Bird & Cage, YOUTUBE (Jan. 23, 2009), http://www.youtube.com/watch?v=yD0ovANHdQ (showing a video of the classic thaumatrope in which a bird on one side of a disc and a cage on the other is twirled so that the bird appears inside the cage).
\end{itemize}
To fair-minded observers it is clear that there were several necessary—but insufficient—laws or policies that caused the crisis.\textsuperscript{105} What were these failures of regulation and policy? An early but unselective account in the Declaration of the Summit on Financial Markets and the World Economy by the leaders of the Group of 20 stated:

During a period of strong global growth, growing capital flows, and prolonged stability earlier this decade, market participants sought higher yields without an adequate appreciation of the risks and failed to exercise proper due diligence. At the same time, weak underwriting standards, unsound risk management practices, increasingly complex and opaque financial products, and consequent excessive leverage combined to create vulnerabilities in the system. Policy-makers, regulators and supervisors, in some advanced countries, did not adequately appreciate and address the risks building up in financial markets, keep pace with financial innovation, or take into account the systemic ramifications of domestic regulatory actions.\textsuperscript{106}

The Financial Crisis Inquiry Commission (FCIC) implemented the most prominent and certainly the most extensive analysis of the crisis. Congress created the FCIC “to examine the causes, domestic and global, of the current financial and economic crisis in the United States.”\textsuperscript{107} The FCIC, spending nearly $10 million, took eighteen months, interviewed over 700 witnesses, reviewed millions of pages of documents, and held nineteen days of public hearings.\textsuperscript{108} Its report made the New York Times’ and Washington Post’s Best-Sellers list,\textsuperscript{109} with the New York Review of Books announcing it as “the definitive history of this period”\textsuperscript{110} and “the most comprehensive indictment of the American financial failure that has yet been made.”\textsuperscript{111} The report was, “[b]y all accounts[,] . . . an

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\textsuperscript{105} TAYLOR, supra note 1, at xi (“What caused the financial crisis? . . . Rarely in economics is a single answer to such questions, but . . . specific government actions and interventions should be first on the list of answers”). The FCIC dissenters captured this notion, noting several factors “were essential contributors to the crisis” but each was “insufficient as a standalone explanation.”


\textsuperscript{107} FCIC REPORT, supra note 3, at 416.

\textsuperscript{108} Id. at xi.


\textsuperscript{111} Id.
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approachable and at times gripping account of the crisis.”112

Although the style was generally praised, the substance faced far more criticism, including from the four dissenting members of the ten-member commission.113 Three Republican members collaborated on a single dissent and a fourth, Peter Wallison from the American Enterprise Institute, a conservative think tank, issued a second dissent.114 As the Republican dissenters noted, the report was “more an account of bad events than a focused explanation of what happened and why. When everything is important, nothing is.”115 The Economist newspaper sniffed, “[d]efinitive the report is not,”116 whereas other reporters noted its “timidity.”117 Peter Wallison criticized not just the substance of the report, “a just so story about the financial crisis,” but the process by which the FCIC majority created its report.118 He charged that the report sought only “the facts that supported its initial assumptions—that the crisis was caused by ‘deregulation’ or lax regulation, greed and recklessness on Wall Street, predatory lending in the mortgage market, unregulated derivatives, and a financial system addicted to excessive risk-taking.”119

The dueling narratives of the FCIC’s majority and dissenting reports essentially follow the competing narratives of the left and right. The majority

112. Hartlage, supra note 3, at 1184.
113. Id. at 1185.
115. FCIC REPORT, supra note 3, at 414.
118. FCIC REPORT, supra note 3, at 444 (Wallison, dissenting).
119. Id. at 443. The report did not adequately explain why so many people did or failed to do so much before the crisis began. Although it serves as a thorough investigation, it fails to offer much explanation or adequate analysis. Notwithstanding its extensive nature, the investigation did not reveal much that was new. See Annie Lowrey, The Financial Crisis Reading List: Do We Really Need an Official Government Report Telling Us How We Got into This Mess?, SLATE (Dec. 16, 2010), http://www.slate.com/articles/business/moneybox/2010/12/the_financial_crisis_reading_list.single.html, archived at http://perma.cc/5XE5-HGMC (arguing that there was little in the report that was not already public and studied). Part of this was due to the statutory design that limited the FCIC’s subpoena power. See Fraud Enforcement and Recovery Act of 2009, Pub. L. No. 111-21, § 5(b)(1)(C)–(D), (b)(3)(B), (d)(2), 123 Stat. 1617, 1625-26, 1628-29 (2009) (specifying required FCIC votes for issuing a subpoena).
The report’s headline conclusion was that “the crisis was avoidable,” adding (perhaps for English majors) that “the fault lies not in the stars, but in us.” Regulators were “sentries . . . not at their posts” as they took “little meaningful action” to address risks caused by increased subprime lending and unregulated derivatives. The poorly regulated marketplace led to the misfeasance and malfeasance of incompetent and unscrupulous executives and employees in the financial sector. More recent books have reached similar conclusions. In contrast, the minority commission voted that the report should not even include terms such as “deregulation,” “Wall Street,” and “shadow banking.” Their dissenting report did not include them.

A. Inadequate Regulation of Subprime Mortgages

In and of themselves, it should be obvious that subprime mortgages are not necessarily bad. They allow people who are higher credit risks to buy homes and thereby participate in the American Dream. But they can be, and were abused. There was undoubtedly some predatory lending, in that lenders sold people mortgages that could only be paid back if housing prices continued to rise.

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120. FCIC REPORT, supra note 3, at xvii.
121. Id.
122. Id. at xviii.
123. Id. at xvii.
124. Id. at xvii-xxv (asserting nine major conclusions about the financial crisis: 1) the financial crisis was avoidable; 2) widespread failures in financial regulation and supervision proved devastating to the stability of the nation’s financial markets; 3) dramatic failures of corporate governance and risk management at many systemically important financial institutions were a key cause of this crisis; 4) a combination of excessive borrowing, risky investments, and lack of transparency put the financial system on a collision course with crisis; 5) the government was ill prepared for the crisis, and its inconsistent response added to the uncertainty and panic in the financial markets; 6) there was a systemic breakdown in accountability and ethics; 7) collapsing mortgage-lending standards and the mortgage securitization pipeline lit and spread the flame of contagion and crisis; 8) over-the-counter derivatives contributed significantly to this crisis; and 9) the failures of credit rating agencies were essential cogs in the wheel of financial destruction).
125. See, e.g., BLINDER, supra note 1, at 27-28 (listing, as factors, the villains of inflated asset prices, particularly of housing and securities: excessive leveraging; lax financial regulation; disgraceful subprime and other mortgage banking practices; unregulated derivatives derived from mortgages; abysmal performance by the ratings agencies; and perverse compensation systems).
127. Id.
Moreover, there were very weak underwriting standards. Mortgage brokers who believed in the “four Cs of credit”—character, capacity, collateral, and capital—were left behind. Originators of mortgages increased the number of low documentation, no documentation, and “no income, no job, no assets” (NINJA) mortgages. Some called these “liar loans,” although liar might refer to either the borrower or anyone involved in arranging the loan. The non-English speaking strawberry-picker, dubbed an “agricultural expert” or “field technician” on the loan documents, who earned $15,000 a year, but qualified for a $720,000 mortgage is illustrative. Partly as a result of this kind of dubious lending, subprime mortgages increased dramatically from less than 7% of all mortgages in 2001 to 20% in 2005. The value of these subprime mortgages in 2005 was $625 billion, with a total outstanding value of nearly $1.25 trillion.

Sheila Bair, then Assistant Secretary of the Treasury, called for increased and improved regulation just before the explosion of subprime mortgages. She wanted federal banking regulators to impose standards on banks and for non-regulated financial entities to commit to compliance with those standards. All she was able to achieve, however, was an unenforceable industry code of best practices.

Moreover, because the originators of these mortgages, such as Countrywide, were securitizing the loans—an originate-to-sell model rather than the traditional originate-to-hold model—they cared much less about whether the mortgages would be repaid. The securitized loans, primarily residential MBSs, spawned

130. See MCLEAN & NOCERA, supra note 2, at 23.
131. POSNER, supra note 14, at 23.
132. FCIC REPORT, supra note 3, at 9.
134. CASSIDY, supra note 2, at 256.
137. Id.
138. Id.
follow-on derivative securities such as CDOs. Any of the four governmental banking agencies (the Federal Reserve, Office of Thrift Supervision, FDIC, and OCC) could have significantly slowed the growth of subprime lending, but none of them did.140 The Federal Reserve bears the most responsibility, as it “was really the only authority that could set lending standards across the board—banks, non-bank lenders, any mortgagor.”

B. Inadequate Regulation of Derivative Financial Products

Subprime mortgages flowed through the entire financial system as their availability and investor demand increased.142 First, investment banks created MBSs.143 To do this, the banks combined thousands of mortgages and then divided them into tranches that each had different risk/reward ratios and, thus, different credit ratings.144 The banks then pooled the payments from the MBSs into CDOs, again with different risks and ratings.145 The banks also used those CDOs to create synthetic CDOs, and so on, until there was an enormous amount of derivative securities that ultimately depended on subprime mortgages for their value.146 Complex derivatives were what Warren Buffet in 2003 famously called “financial weapons of mass destruction, carrying dangers that . . . are potentially lethal,”147 suggesting they might cause “serious systemic problems.”

of Credit Risk Management and Corporate Governance, UNIV. OF PENN. 1, 2 (Feb. 9, 2010), available at http://fic.wharton.upenn.edu/fic/papers/10/10-12.pdf (discussing how “the ‘originate-to-distribute’ model distort[ed] incentives for risk taking, since lenders no longer had ‘skin in the game’”).

140. As Alan Blinder asks, “[d]id the regulators really believe that subprime mortgage lending could expand that rapidly without deterioration of quality?” BLINDER, supra note 1, at 58. He later explains that the choice is either deterioration of quality or that a “huge number of creditworthy subprime borrowers suddenly appeared out of nowhere.” Id. at 70.

141. See Lizza, supra note 136.


144. Id. at 125.


148. Id. at 14. Indeed, before the crisis derivatives caused such high-profile collapses as Enron in 2001 and Long Term Capital Management in 1998. See, e.g., Randall Dodd, Derivatives
Brooksley Born, then Chair of the Commodity Futures Trading Commission (CFTC) in 1998, proposed regulating what she called a “completely dark market” of over-the-counter derivatives. Robert Rubin and Larry Summers, among other members of the Clinton Administration, strongly criticized the concept paper. A key idea was that derivatives should be traded on an exchange with a central counterparty, rather than as individual contracts between parties. The central counterparty would guarantee the performance of the contract, thereby reducing the buyer’s and seller’s risk that the other would default. As it was by accepting the seller’s credit risk, credit default swap buyers did something akin to “buying insurance for the Titanic from someone on the Titanic.”

Congress, however, chose instead of regulation a laissez-faire approach, with the Commodity Futures Modernization Act of 2000 (CFMA). Ironically, the CFMA expressly intended “to reduce systemic risk and provide greater stability to markets during times of market disorder.” This legislation ensured that nearly all over-the-counter derivatives traded between wealthy or sophisticated parties were not directly regulated. As a result, derivatives reached an


149. Frontline: Interview: Brooksley Born (PBS television broadcast Aug. 28, 2009), available at http://www.pbs.org/wgbh/pages/frontline/warning/interviews/born.html archived at http://perma.cc/VY9Z-9NZY (“What was it that was in this [over the counter derivative] market that had to be hidden? Why did it have to be a completely dark market?”).

150. See Over-the-Counter Derivatives, 63 Fed. Reg. 26114 (proposed May 12, 1998). (“[Over-the-Counter] derivatives are contracts executed outside of the regulated exchange environment whose value depends on (or derives from) the value of an underlying asset, reference rate, or index.”).


152. Id. at 5.


157. The CFMA used the term “Eligible Contract Participants” which are defined in § 101.
estimated notional value of nearly $600 trillion by 2007. One of Nobel Laureate Paul Krugman’s favored explanations is that “[r]egulation didn’t keep up with the system.” Likewise, Nobel Laureate Joseph Stiglitz said more cautiously, “it is absolutely clear to me that if we had restricted the derivatives, some of the major problems would have been avoided.” Current Federal Reserve Chairman Ben Bernanke seems to agree. Most agree that the CFMA was a significant cause of the crisis.

However, even if the CFMA helped magnify the crisis, part of the uncertainty concerns the counterfactual of what the alternative would have been. It does not appear likely that Congress would have permitted the CFTC to regulate derivatives even in the CFMAs absence. Great regulation, maybe even good regulation, could have prevented the growth of harmful derivatives. On the other hand, bad regulation, or even the CFTC’s proposed regulation, might not have had the desired effect. A centralized exchange, for example, might simply increase the demand for derivatives and concentrate the credit risk. It remains unknown what kinds of regulations would have been feasible, had they only been proposed in place of the CFMA.

C. Inadequate Regulation of the Rating Agencies

Credit ratings agencies—or more precisely the nationally recognized
securities ratings organizations or NRSROs—are supposed to rate the riskiness of securities. In 2003 there were only three agencies approved by the SEC as NRSOss, Standard & Poor’s (S&P), Fitch, and Moody’s. This privileged position allowed these agencies to grow quickly, doubling revenues from 2002 to 2006, with Moody’s having “the highest profit margin of any company in the S&P 500 for five years in row.”

The ratings bestowed upon securities by the rating agencies were absolutely critical, because other regulations, like the SEC’s “net capital rule,” depended on them. Some investors, for example, are only permitted to buy certain grades of investments. As the SEC observed in 2003, “ratings by NRSROs today are widely used as benchmarks in federal and state legislation, rules issued by financial and other regulators, foreign regulatory schemes, and private financial contracts.” The FCIC was thus able to conclude, “[t]he mortgage-related securities at the heart of the crisis could not have been marketed and sold without their seal of approval.” Once the securities were sold, however, their value collapsed following homeowners’ default on mortgages. Rating agencies gave top triple A investment-ratings to securities that in fact were very risky.


170. FCIC REPORT, supra note 3, at xxv.

171. See Holt, supra note 143, at 120 (discussing the primary causes of the housing bubble and the resulting credit crisis).

172. See Matt Krantz, 2008 Crisis Still Hangs Over Credit-rating Firms, USA TODAY, Sept.
Rating agencies looked at the combined payouts from low ranked tranches of the mortgage-backed securities into CDOs, and gave the new securities investment grade ratings. Like when Rumpelstiltskin turned straw into gold, the rating agencies’ ratings transformed junk securities into investment grade securities. Combining a large number of risky payments (the subprime mortgages combined into MBS) could theoretically create less risky security if the payments were sufficiently independent of each other. The problem was not with the theory, it was that payments were not independent of each other. The rating agencies’ models apparently failed to include possibilities like a nationwide decline in the price of housing. Standard & Poor’s chief credit officer later admitted the model they used was barely better than flipping a coin. With the benefit of hindsight, the optimistic rating of the securities built on subprime mortgages was perhaps the largest mispricing of risk ever.

Why were the rating agencies’ models and thus their ratings so colossally wrong? Some answers include conflicts of interest, related competitive pressures (or sometimes a lack of competition), incompetence, or perhaps simply the problem of rating a very complicated security. The most important factor may be


173. See id. (discussing the role of credit-rating firms’ ratings in marketing risky mortgage-backed securities, such as CDOs).


175. See Hsu, supra note 174 (discussing why CDOs are risky if the default probabilities are not independent of each other).


178. See Lang & Jagtiani, supra note 139; Aline Darbellay & Frank Partnoy, Credit Rating Agencies Under the Dodd-Frank Act, 30 BANKING & FINANCIAL SERVICES POLICY REPORT 1, 2 (2011) (noting, for example, that “[i]n 2006, 869 billion US dollars of mortgage-related securities were rated triple-A by Moody’s and 83 percent went on to be downgraded within six months”).

179. See LEWIS, supra note 2, at 156 (describing how the best analysts would leave for higher paying investment banking jobs).

well be the conflicts of interest. A conflict of interest can lead to biased behavior without any conscious malfeasance. See, e.g., Antony Page, Unconscious Bias and the Limits of Director Independence, 2009 U. ILL. L. REV. 237, 259.


183. Id.


185. Id.


188. LEWIS, supra note 2, at 99-100.


190. Id.

191. Id.
2004, the SEC allowed the large investment banks to regulate their own capital levels.\footnote{192} Leverage then increased.\footnote{193} Merrill’s leverage doubled, for example.\footnote{194} Bear Stearns went to $33 of debt for every dollar of equity.\footnote{195} Of course this didn’t last long, because all five investment banks stopped being investment banks—Lehman went bankrupt, Bear and Merrill were acquired, and Goldman and Morgan Stanley became banks.\footnote{196}

Leverage, understood as the ratio of assets to capital, was too high.\footnote{197} In essence, the higher the leverage, the greater the chance of a company failing.\footnote{198} Bear Stearns and Lehman Brothers both had leverage of over thirty (i.e., for every dollar of capital (equity) there was more than thirty dollars of assets.)\footnote{199} In contrast, a mortgage with the traditional 20% down payment would have a ratio of five, a slimmer 10% down payment would have ten, a 1% down payment would have one hundred, and if a buyer paid no down payment at all, the ratio would be infinite.\footnote{200}

While most parties agree that leverage before the crisis was too high, the cause of this is disputed.\footnote{201} At the time, and for at least a few years after the crisis, commentators claimed that the increase in leverage resulted from a 2004 change in SEC rules.\footnote{202} Respected economists such as Alan Blinder, for example,
stated that leverage shot up from around twelve-to-one to thirty-three-to-one as a result of this change, as did Kenneth Rogoff and others, including noted law professor John C. Coffee. Daniel Gross in Slate Magazine stated, “Perhaps the most disastrous decision of the past decade was the Securities and Exchange Commission’s 2004 rule change allowing investment banks to increase the amount of debt they could take on their books.”

The rule at issue, SEC Rule 15c3-1, although complicated, did not significantly affect the relevant leverage. In particular, the rule targeted leverage at the holding company level (which had been unaffected by the earlier version of Rule 15c3-1) rather than at the broker dealer level. Some of the companies that were later alleged to have increased their leverage ratios after 2004 had ratios of twenty-eight to one in 1998—higher than their ratios at the end of 2006. For those who wanted to see a failure of (or permissive) regulation, this was a plausible story, even though publicly available information would have readily disproved it.

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204. Reinhart & Rogoff, * supra* note 1, at 214 (referring to the “2004 decision of the Securities and Exchange Commission to allow investment banks to triple their leverage ratios (that is, the ratio measuring the amount of risk to capital)” as a huge regulatory mistake); see also Roubini & Mihm, * supra* note 1, at 75; Stiglitz, * supra* note 1, at 163.


207. 17 C.F.R. § 240.15c3-1 (2005) (net capital requirements for brokers or dealers).


210. U.S. Gov’t Accountability Office, Rep. No. GAO-09-739, at 40 (2009) (finding that “of four of the five broker-dealer holding companies that later [were covered by Rule 15c3-1]. . . three had ratios equal to or greater than 28-to-1 at fiscal year end 1998, which was higher than their ratios at fiscal year-end 2006 before the crisis began”), available at http://www.gao.gov/assets/300/292767.html; see also FCIC REPORT, * supra* note 3, at 153-54 (noting that although leverage at the investment banks increased in 2004-07, in most cases it had been higher in the late 1990s). Leverage in fact has fluctuated an enormous amount, ranging from below eight to one in the early 1970s to occasionally exceeding thirty-five to one in the 1950s. See Cohan, * supra* note 209.


212. See McLean & Nocera, * supra* note 2 (describing how a semi-retired lawyer and a
E. Low Interest Rates

Another area of dispute is the role of Greenspan’s low-interest rate policy. Alan Greenspan kept interest rates low, arguably too low, in the early 2000s. This could have contributed to the growth of the real estate bubble, as a would-be home buyer’s monthly payments could support higher mortgages and thus higher prices. More precisely, to form a bubble, housing prices would increase by more than they should increase, as standard economic theory “says that low interests rates should increase house values (or the value of any long-lived asset for that matter).” Lower interest rates might also have contributed to the crash by encouraging greater demand for the higher-yielding derivative securities that magnified the crisis. More indirectly, low interest rates can bring about reduced saving because saving becomes less attractive.

The dispute is not so much over interest rate’s causal role, but rather over its extent. Professor John B. Taylor argues that unusually low interest rates, set in deviation from past practices and precedents, “should be first on the list of answers to the question of what went wrong.” Judge Richard Posner is in the same camp, asserting that low interest rates were one of two “dangerous developments” that resulted in the crisis. John A. Allison, Chief Executive Officer of BB&T, a large financial service company, for nearly 20 years until retired investment banker identified the error).


214. By way of example, $100,000 borrowed on a thirty year mortgage at 5% interest requires a monthly payment of $537. The same monthly payment with a 10% interest rate only supports borrowing of $58,419. http://www.bankrate.com/calculators/mortgages/how-much-money-can-i-borrow.aspx.

215. Kenneth Kuttner, Low Interest Rates and Housing Bubbles: Still No Smoking Gun, at 160, in THE ROLE OF CENTRAL BANKS IN FINANCIAL STABILITY (Douglas Evanoff ed., 2013), (emphasis in original), available at http://web.williams.edu/Economics/wp/Kuttner-smoking-gun.pdf, archived at http://perma.cc/RRD6-FFDE; see also id. at 160-64 (explaining the impact of interest rates on housing prices). Kuttner goes on to argue that credit might have become looser due to lowered lending standards and increased securitization of loans. Id. at 181.


217. TAYLOR, supra note 1, at 61. John B. Taylor is a professor of economics at Stanford University, and is a former Under Secretary of the U.S. Treasury for International Affairs. He was also a member of the President’s Council of Economics Advisors.

218. POSNER, supra note 14, at 315. The other development that led to the crisis according to Posner was deregulation. Id.
2008, claims it was the “primary cause.”

Most economists disagree. In 2010, the Wall Street Journal provided a sampling of the views of economists who were part of the National Bureau of Economic Research’s Monetary Policy Program posed with the question “whether low interest rates caused the housing bubble.” Without being too technical, economists disputed whether interest rates were that much lower in the relevant time period; if they were, whether the impact was significant; and whether the Federal Reserve itself could have done very much. Those who agreed that low interest rates were a significant cause included it as one of several causes rather than a top or leading cause.

The FCIC essentially gave Greenspan and interest rate policy a free pass, concluding that “excess liquidity did not need to cause a crisis,” which is no doubt correct, if one accepts that there were no causes that were sufficient on their own. Easy credit, however, appears to be very important: “[i]n a modern

221. Id.
222. Id. (quoting Christopher House stating, “[w]hile the interest rate was below normal for some time it may not have been far below normal” and Kenneth Kuttner pointing out that “[t]he ‘bubble’ didn’t really get going until 05-06, by which time the Fed had raised rates to more or less normal levels.”). The article overall reminds one of the old line attributed to George Bernard Shaw, “if all economists were laid end to end they would not reach a conclusion.” (available at http://www.quotationspage.com-quote/23681.html).
223. Id. (quoting Brad Delong, arguing that lower than usual interest rates would have led to only a 6% increase in prices); see also Kuttner, supra note 215, at 22 (arguing that “all available evidence . . . points to a rather small effect of interest rates on housing prices.”); Peter Wallison, Was The Financial Crisis Caused By Monetary Policy? Comments On A Speech By John B. Taylor (Jan. 4, 2013), http://www.aei.org/speech/economics/financial-services/comments-on-a-speech-by-john-b-taylor/, archived at http://perma.cc/W8GW-3YE9 (presenting charts showing that much of the housing pricing boom occurred before the period of unusually low interest rates).
224. Economists’ Views, supra note 220 (quoting Chris Sims saying, “[t]here may not have been a great deal that the Fed itself, without legislative cooperation, could have done about the situation as the housing bubble developed” and Jonathan Parker noting that “Fed did not have the legal authority to change or enforce regulations in most of the areas where these actions could have mitigated the crisis”). Alan Greenspan himself doubts whether there was much the Federal Reserve could have done. See Kristina Cooke, Recession Will Be Worst Since 1930’s: Greenspan, REUTERS (Feb. 18, 2009), http://www.reuters.com/article/2009/02/18/us-usa-fed-greenspan-idUSTRE51H0X20090218, archived at http://perma.cc/L58B-PF8J.
225. Economists’ Views, supra note 220 (quoting Michael Bordo who stated there were several causes of the housing boom but low interest rates “provided much of the fuel”).
226. FCIC Report, supra note 3, at xxvi. Low interest rates typically result increased liquidity. See, e.g., RAJAN, supra note 1, at 168.
economy with a large financial sector, the combination of cheap money and lax oversight, if maintained for years on end, is sure to lead to trouble.”227 Likewise, an *Economist* article concluded, “[a]sk people in property what caused the crisis and the answer will invariably be the amount of liquidity in the system.”228

**F. Government Housing Policy**

Perhaps the most heated dispute has been over the role of the government’s housing policy in leading to the crisis. The federal government has long encouraged home-ownership—witness the mortgage deduction from income tax—and succeeding administrations have made it a priority.229

Of government policies, the Community Reinvestment Act’s (CRA)230 role in the crisis has been most controversial.231 The CRA, passed in 1977, was primarily targeted at “redlining,” the refusal to lend to some borrowers (typically minorities) and neighborhoods regardless of credit-worthiness.232 A more loaded description is that the CRA’s “real purpose was to force banks to make loans to low-income borrowers, especially minorities and particularly African-Americans.”233 It required federal regulators to evaluate banks’ performance in lending to lower income borrowers and communities where banks have a presence, and consider these evaluations on banks’ expansion plans.234 The CRA did not, however, set minimum targets or quotas.235

The FCIC concluded it “was not a significant factor” in the financial crisis

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228. *The Official Verdict,* supra note 116. Some of that liquidity may also have been caused by an influx of foreign capital. *Id.*
231. Compare Raymond H. Brescia, *The Cost of Inequality: Social Distance, Predatory Conduct, and the Financial Crisis,* 66 N.Y.U. ANN. SURV. AM. L. 641, 693-700 (2010) (concluding that the Community Reinvestment Act and government sponsored entities were not to blame for the crisis), with *Rajan,* supra note 1, at 8-9 (arguing that politicians used easy credit policies to “mollify” the masses).
233. *See Allison,* supra note 219, at 55.
235. Some have argued that although there are no explicit targets, “there are implied quotas for low-income minority loans (especially for African Americans).” *See Allison,* supra note 219, at 55. He also claims that the Fair Housing Act (1968) and Equal Credit Opportunity Act (1979) were in practice “used to give banks incentives to make loans to low-income members of minority groups.” *Id.*
based on their finding that “only 6% of high-cost loans—a proxy for subprime loans—had any connection to the law.” 236 This is partially because the CRA only directly covers banking institutions, and not other mortgage originators such as credit unions.237 Others have observed that because the crisis was primarily a result of defaults on mortgages originated between 2005 and 2007, any link for the CRA is attenuated given that there were no relevant substantive changes to the CRA after 1995.238 The conclusion is bolstered by the finding that CRA-linked loans and similar loans that are unrelated to the CRA “perform comparably,”239 although some have claimed that the default rates have been “extraordinarily high.”240

The FCIC also concluded that with respect to the GSEs, their involvement was limited to following other lenders into the market rather than leading the charge.241

In his FCIC dissent, Peter Wallison claimed the “sine qua non of the financial crisis was U.S. government housing policy.”242 Wallison, among others, charged that it was U.S. government housing policy that encouraged home ownership among those with lower income.243 This resulted in an overheated housing market and an increase in home ownership from the long-existing 64% in 1965 to nearly 70% by 2004.244

He notes that by 2007, half of U.S. mortgages (28 million) were subprime or weak, and of these, 74 percent “were on the books of government agencies or others subject to government requirements.”245 His report was dismissed as “a lonely, loony cri de coeur.”246

Shifting ground somewhat, Allison argues that the legal responsibility to facilitate low-income home ownership became an ethical responsibility or duty,247

236. FCIC REPORT, supra note 3, at xxvii; see also Neil Bhutta & Glenn B. Canner, Community Dividend: Did the CRA Cause the Mortgage Market Meltdown?, FED. RES. BANK OF MINNEAPOLIS (Mar. 1, 2009), available at http://www.minneapolisfed.org/publications_papers/ub_display.cfm?id=4136& (determining the 6% figure after carving out loans from lenders that were not regulated by the CRA and to borrowers who were no lower-income or in a CRA assessment area, and acknowledging possible inaccuracies in the figure).

237. Id.
238. Id.
239. Id.
240. ALLISON, supra note 219, at 56.
241. See FCIC REPORT, supra note 3, at xxvi.
242. See id. at 444 (Wallison, dissenting).
243. See id. (Wallison, dissenting).
244. See id. at 456 (Wallison, dissenting).
245. Wallison, supra note 114.


247. ALLISON, supra note 219, at 56.
and acknowledges the “ethical justification was more important.”

F. Repeal of Glass-Steagall

It is also worth mentioning one oft-cited cause that probably was not a cause at all: the repeal of the Glass-Steagall Act. The Glass-Steagall Act, enacted in 1933 separated commercial banking from investment banking. It was repealed by the Gramm-Leach-Bliley Act of 1999. It is hard to see how this would be a plausible cause. Glass-Steagall never regulated the shadow-banking system, which is what caused the crisis. Moreover, absent its repeal, JP Morgan would have been unable to buy Bear Stearns and the same for Bank of America’s purchase of Merrill Lynch, which would have made the crisis far worse. Glass-Steagall’s repeal does, however, fit a narrative where rampant deregulation is the cause of the financial crisis.

CONCLUSION

There were plenty of necessary causes of the financial crisis, but no sufficient causes. With the benefit of hindsight, it is clear there were many parties who, had they acted differently, could have prevented the financial crisis, or at least mitigated its impact. Regulators failed to effectively regulate. The credit rating agencies used weak models, based on inadequate information, with an inherent conflict of interest. Buyers and sellers of securities did not adequately investigate the securities they were buying. Mortgage lenders and the support industry, such as appraisers, failed to behave ethically. And, of course, home buyers were perhaps too optimistic about their earnings prospects or the housing market, or

248. Id. at 57.


251. See Gari, supra note 232, at 163 (“Glass Steagall . . . firewalls could not stop the creation of a shadow banking system of derivatives, special purpose vehicles, and credit default swaps, all of which served the purpose of hedging and profiting from the risk of subprime loans”).

sometimes just were misinformed or did not understand. The appropriate lesson is not a binary conflict between deregulation and regulation, but rather better and smarter regulation.\textsuperscript{254} This also suggests that even though greed remains a fundamental aspect of human nature, an appropriate set of rules can greatly reduce, if not prevent, the chances of another such crisis.\textsuperscript{255}

\textsuperscript{254} Ben S. Bernanke, \textit{Monetary Policy and the Housing Bubble} (Jan. 3, 2010), http://www.federalreserve.gov/newsevents/speech/bernanke20100103a.htm, archived at http://perma.cc/ZQ5H-FTKK (“[T]he lesson I take from this experience is not that financial regulation and supervision are ineffective for controlling emerging risks, but that their execution must be better and smarter.”).

\textsuperscript{255} As the FCIC noted “to pin this crisis on mortal flaws like greed and hubris would be simplistic. It was the failure to account for human weakness that is relevant to this crisis.” FCIC REPORT, supra note 3, at xxii-xxiii.