

## THE SUBPRIME CRISIS—A TEST MATCH FOR THE BANKERS: GLASS-STEAGALL VS. GRAMM- LEACH-BLILEY

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### I. INTRODUCTION

The United States has just experienced one of the worst financial crises in all its 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.<sup>1</sup> Some 140 commercial banks failed in 2009 as a result of the crisis,<sup>2</sup> and several large commercial banks had to be rescued or bailed out as well, including Citigroup, Bank of America and Wachovia Corp.<sup>3</sup> Several giant residential mortgage lenders failed, including 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.<sup>4</sup> Total job losses exceeded 7.2 million.<sup>5</sup> The problem spread worldwide. In the United Kingdom, financial services crippled by the crisis included the Royal Bank of Scotland, Lloyds TSB, and Northern Rock. Banks in Germany and France

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1. 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.

2. The Associated Press, *Seven Bank Failures Bring the Total to 106 for the Year*, N.Y. TIMES, Oct. 24, 2009, at B4.

3. See Eric Dash, *Seeking A Roadway To Solvency*, N.Y. TIMES, Nov. 25, 2008, at B1 (explaining that after Citigroup received its second multi-billion dollar rescue from Washington, rivals Bank of America, JPMorgan Chase, and Wells Fargo could line up for additional support).

4. The Associated Press, *Rise in New Jobless Claims Was Higher Than Expected*, N.Y. TIMES, Oct. 23, 2009, at B8.

5. *Id.*

had to be rescued too. Ireland and Iceland's major banks had to be bailed out or nationalized.<sup>6</sup>

This debacle touched off a debate about whether the 1999 Gramm-Leach-Bliley Act's ("GLBA") removal of the dividing line between commercial and investment banking activities<sup>7</sup>—which had been implemented by the Glass-Steagall Act of 1933<sup>8</sup>—laid the groundwork for the subprime crisis.<sup>9</sup> 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

### A. *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 the Jeffersonian 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 economy. This debate over the role of banks in society has been, at least before the subprime crisis, purely an American one. The American experience is colored by the fact that during the colonial period, the English Crown effectively prohibited banking in the colonies.<sup>10</sup> This left the nation to develop its own banking system after the Revolution. Hamilton, as Secretary of the Treasury, laid the groundwork

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6. For a description of the failures occurring during the subprime crisis, see DAVID WESSEL, IN FED WE TRUST 229, 233 (2009).

7. Financial Services Modernization Act of 1999, Pub. L. No. 106-102, § 101, 113 Stat. 1338, 1341 (codified as amended at 15 U.S.C. §§ 6801-09 (2006)).

8. Banking Act of 1933, ch. 89, Pub. L. No. 73-66, 48 Stat. 162 (codified as amended at 12 U.S.C. § 227 (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) (noting that the Financial Services Modernization Act was "directly responsible for bringing the entire world to the brink of financial ruin").

10. See Christian C. Day, *Dispersed Capital and Moral Authority: The Paradox of Success in the Unregulated 19th Century New York Capital Markets*, 12 LAW & BUS. REV. AM. 303, 304 (2006) (noting that the British Parliament extended the Bubble Act to the colonies, requiring the creation of all joint stock corporations to obtain the permission of Parliament or the Crown).

for that effort through a 1790 proposal for the creation of a “Bank of the United States” (“BUS”), which would perform the functions of a central bank.<sup>11</sup> Hamilton’s proposal for this central bank was modeled after the Bank of England and, to some extent, the central banks on the continent.<sup>12</sup> His recommendation proved to be controversial. Some cabinet members, including Attorney General Edmund Randolph and Secretary of State Thomas Jefferson—who believed that “banking establishments are more dangerous to our liberties than standing armies”<sup>13</sup>—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.<sup>14</sup>

Even Hamilton concluded that the BUS should be a creature with limited powers. He believed that it should be safeguarded from commercial and speculative operations.<sup>15</sup> The bank’s charter, therefore, prohibited the BUS from investing in land or buildings and from dealing in goods, wares, merchandise, or commodities. It further provided that bounties would be paid to anyone reporting violations of those proscriptions.<sup>16</sup> Despite those limitations, the BUS became a 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.<sup>17</sup>

The BUS became a victim of its own success. Competing private banks resented the BUS and were able to prevent its charter renewal by the Congress in 1811.<sup>18</sup> The liquidation of the BUS as a national bank left the country adrift financially, leading to a financial crisis during the War of 1812.<sup>19</sup> Awakening to its value, Congress chartered a new BUS in 1816.<sup>20</sup>

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11. RON CHERNOW, *ALEXANDER HAMILTON* 344 (2004).

12. *See id.* at 347 (2004) (noting that Hamilton “stressed his desire to catch up with European experience”).

13. WILLIAM F. HIXSON, *TRIUMPH OF THE BANKERS: MONEY AND BANKING IN THE 18TH AND 19TH CENTURIES* 94 (1993) (citation omitted).

14. For an account of this debate in the Washington cabinet see WILLARD STERNE RANDALL, *THOMAS JEFFERSON: A LIFE* 505-07 (1993) (describing the debates surrounding Hamilton’s proposal).

15. 1 JERRY W. MARKHAM, *A FINANCIAL HISTORY OF THE UNITED STATES: FROM CHRISTOPHER COLUMBUS TO THE ROBBER BARONS* 89 (2002).

16. *Id.*

17. *Id.* at 90.

18. *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) (explaining that agrarian and state bank interests defeated the rechartering of the first BUS).

19. MARKHAM, *supra* note 15, at 89.

20. *Id.* at 134.

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.<sup>21</sup>

Despite its usefulness, populist politicians—who thought the BUS had aggregated too much power unto itself—despised 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. Clay 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.<sup>22</sup>

Following the demise of the second BUS, banks became solely creatures of the states, and were regulated only loosely by state governments.<sup>23</sup> However, the Civil War led to the creation of national bank charters and a “dual” banking system. Under this system, a bank could choose to be regulated by its own state regulators by adopting a state charter, or could elect to be a national bank regulated by the Office of the Comptroller of the Currency (“OCC”) in the Treasury Department.<sup>24</sup> 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, however, because their depository facilities and checking operations were still a valuable service for customers.<sup>25</sup>

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21. 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) (noting the large number of state-chartered banks that engaged in questionable financial practices).

22. 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) (discussing the beginning of the bank war, the veto, and the counterattack).

23. 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. Fed. Reserve Bank of N.Y.*, 34 F.2d 910, 912 (2d Cir. 1929).

24. 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 depositories 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*, 34 F.2d at 912.

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

### B. Banking Powers

The state banks had been leaders in investment banking and were free to engage in underwriting and dealing activities in stocks.<sup>26</sup> National banks, however, were restricted in their investment and operation powers to matters specified in the National Bank Act of 1864,<sup>27</sup> plus any “incidental” powers needed to carry out that business.<sup>28</sup> For example, Section twenty-eight of that legislation restricted national banks to real estate holdings in properties necessary to transact their own businesses and to real estate mortgages only as security or payment for “previously contracted” debts.<sup>29</sup> Dealing in stocks by national banks was “not expressly prohibited; but such a prohibition [was] implied from the failure to grant the power.”<sup>30</sup> National banks were allowed to broker securities for customers,<sup>31</sup> but the OCC ruled in 1902 that national banks did not have the power to act as underwriters of stocks.<sup>32</sup> 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.<sup>33</sup> Before the passage of that legislation,

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26. George G. Kaufman & Larry R. Mote, *Glass-Steagall: Repeal by Regulatory and Judicial Reinterpretation*, 107 BANKING L.J. 388, 391-92 (1990).

27. National Bank Act of 1864, ch. 106, 13 Stat. 99 (codified as amended at 12 U.S.C. § 21 *et seq.* (2006)).

28. *First Nat’l Bank of Charlotte v. Nat’l Exch. Bank of Balt.*, 92 U.S. 122, 127 (1875).

29. 12 U.S.C. § 28.

30. *First Nat’l Bank of Charlotte*, 92 U.S. at 122.

31. *Block v. Pa. Exch. Bank*, 170 N.E. 900, 901 (N.Y. 1930).

32. 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. 483, 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, at 6.

33. 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

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.<sup>34</sup> The National City Co. was funded with a forty percent dividend on its twenty-five million dollars in stock, which was assigned to three bank officers acting as trustees with the sole power to vote the National City stock. Unlike the bank, the National City Co. had no limitations on its powers and could engage in any lawful business.<sup>35</sup>

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.<sup>36</sup>

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."<sup>37</sup> However, Franklin MacVeagh, the

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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.

Eaton, *supra* note 32, at 1192 (citations omitted).

34. See 2 JERRY W. MARKHAM, A FINANCIAL HISTORY OF THE UNITED STATES: FROM J.P. MORGAN TO THE INSTITUTIONAL INVESTORS (1900-1970) 23 (2002) (noting that after the Comptroller of the Currency ordered the national banks to restrict their underwriting activities, banks responded by forming banking affiliates who could still underwrite).

35. See JOHN K. WINKLER, THE FIRST BILLION: THE STILLMANS AND THE NATIONAL CITY BANK 202-03 (1934) (finding that the National City Company had made investments in multiple banks and trust companies and thereby became a holding company of banks).

36. *Id.* at 206 (emphasis provided).

37. *Id.*

Secretary of the Treasury and a former long time director of the Commercial National Bank of Chicago, disagreed with that claim.<sup>38</sup> The matter was then submitted to President William H. Taft, who Franklin A. Vanderlip—president of the National City Bank—and Henry P. Davidson—a partner at J.P. Morgan—convinced to suppress the Solicitor General’s opinion at a secret White House meeting in 1911.<sup>39</sup> “The original copy of the Lehman opinion had disappeared from the files of the Justice Department sometime prior to 1913, so that only a carbon copy remained.”<sup>40</sup> The Senate Banking and Currency Committee discovered the copy of Lehman’s opinion during its 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, laying the groundwork for the passage of the Glass-Steagall Act in the following year.<sup>41</sup>

### C. *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.<sup>42</sup> 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.<sup>43</sup> Senator Nelson Aldrich served as the head of the Commission, but private bankers largely controlled the lengthy and detailed studies that it conducted.<sup>44</sup>

Disguised as duck hunters, a group of those bankers met on Georgia’s Jekyll Island in 1910 and came up with a plan for a central banking system controlled by private banks.<sup>45</sup> Democrats blocked that proposal, but Congressman Carter Glass from Virginia—the future co-

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38. FERDINAND LUNDERG, *AMERICA’S 60 FAMILIES* 102-03 (1937).

39. *See id.* (noting that, with this decision, “Taft threw a very special favor in the way of the Rockefellers’ National City Bank and became personally responsible for the sinister flowering of bank securities affiliates”).

40. Perkins, *supra* note 32, at 517.

41. *Id.*

42. *See* ROBERT F. BRUNER & SEAN D. CARR, *THE PANIC OF 1907* (2007) (describing the 1907 panic). For a description of Morgan’s role in this rescue, see JEAN STROUSE, *MORGAN: AMERICAN FINANCIER* 573-96 (1999) (detailing a more nuanced view of the life of the man regarded by peers to be a sinister capitalist).

43. 35 Stat. 546 (1908), *repealed by* Technical Amendments to the Federal Banking Laws, Pub. L. No. 103-325, 108 Stat. 2292, 2294 (1994).

44. RON CHERNOW, *THE HOUSE OF MORGAN* 129-30 (1990).

45. G. EDWARD GRIFFIN, *THE CREATURE FROM JEKYLL ISLAND* 7-8 (1994).

sponsor of the Glass-Steagall Act—brokered a compromise on behalf of the Woodrow Wilson administration.<sup>46</sup> That compromise adopted the concept of regional Federal Reserve banks that would be owned and controlled by private member banks and—as Wilson and Glass insisted—supervised by an oversight board controlled and appointed by the government in Washington: the Federal Reserve Board.<sup>47</sup> With that compromise, Congress passed the Federal Reserve Act in 1913.<sup>48</sup>

*D. The Pujo Committee*

An investigation performed by the House Committee on Banking and Currency, which 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.<sup>49</sup> 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 banks were using their affiliates to evade regulatory restrictions on bank securities activities, which of course, they were.<sup>50</sup> Nothing came of that criticism, however, at least until the passage of the Glass-Steagall Act.

*E. The Stock Market Crash of 1929*

The securities affiliates of the large banks provided a mechanism for the banks 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), in addition to 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 crash.<sup>51</sup> The National City Co. had offices in fifty-eight cities and employed a private wire system 11,000

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46. 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. 1 ALLAN H. MELTZER, A HISTORY OF THE FEDERAL RESERVE (1913-1951) 67 n.4 (1989).

47. CHERNOW, *supra* note 44, at 129-30.

48. Federal Reserve Act, Pub. L. No. 63-43, 38 Stat. 251 (1913).

49. H.R. REP. NO. 62-1593, pt. 3, ch. 3, at 129-30 (1913).

50. *Id.* at 173.

51. 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) (citing S. KENNEDY, THE BANKING CRISIS OF 1933, at 212 (1973)).

miles in length. It 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.<sup>52</sup>

The National City Co. was headed by Charles Mitchell, who became infamous for his encouragement that national securities should sell 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.”<sup>53</sup> Some of the stock and bond sales by the National City Co. turned out to be disastrous for investors. Of particular concern was a series of Republic of Peru bonds, which totaled \$90 million. National City Co. made no effort to determine whether Peru would be able to service the bonds, and the bonds soon went into default. Investors bought the bonds for \$90, but they were trading at less than \$5 after the Stock Market Crash of 1929.<sup>54</sup>

Charles Mitchell raised more concerns after he became the head of the National City Bank. He began a program of promoting the bank’s stock through the National City Co. and engaged in speculative trading of National City Bank’s own stock, driving its cost up from \$20 to \$580 per share.<sup>55</sup> Since he was president of the National City Bank, Mitchell had the opportunity to serve as a director of the Federal Reserve Bank of New York in 1929. Ignoring the obligations of that office, 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 the Fed’s effort to cool speculation, that the National City Bank would inject \$25 million into the call market. He hoped that this action would drive interest rates down and make increasing amounts of funds available in the stock market, which would ensure the market’s continuing liquidity.<sup>56</sup>

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52. MARKHAM, *supra* note 34, at 116.

53. LIAQUAT AHAMED, *LORDS OF FINANCE: THE BANKERS WHO BROKE THE WORLD* 312 (2009).

54. 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) (noting that this was one of the largest scams responsible for the downfall of the market).

55. MARKHAM, *supra* note 34, at 117.

56. AHAMED, *supra* note 53, 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

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.<sup>57</sup>

The horrors of the Great Depression need not be recounted here; it is sufficient to say that the nation was broken economically and the banking system was wrecked.<sup>58</sup> Over 1,300 banks failed in 1930. Another 2,000 banks failed in 1931. By 1932, twenty-five percent of all banks in the United States had failed.<sup>59</sup> The Federal Reserve Board played no meaningful role in preventing the Great Depression and actually did much to prolong it.<sup>60</sup> “Ironically, the very existence of the Federal Reserve

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(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*.

57. Langervoort, *supra* note 51, at 694 (footnotes omitted).

58. See T.H. WATKINS, *THE GREAT DEPRESSION* (1993) (describing those hardships). As another author described the worldwide effects of the Great Depression:

[R]eal 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 53, at 497.

59. MARKHAM, *supra* note 34, at 161.

60. As noted by Ben Bernanke before he became chairman of the Federal Reserve: “The monetary policy of the 30’s led to a deflation which created, among other things, the

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.”<sup>61</sup>

*F. 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 Corporation (“FDIC”), which insured bank deposits from the risk of insolvency.<sup>62</sup> This created a moral hazard that would be realized in future years,<sup>63</sup> but it did restore faith in the banking system and many banks were able to reopen as a result.

Congress was also concerned with the mortgage lending activities of national banks. The McFadden Act, which it had passed in 1927, had allowed national banks to make residential mortgage loans. The national banks then expanded their mortgage activity “dramatically.”<sup>64</sup> That increase in 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.”<sup>65</sup> 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.”<sup>66</sup> The Fed’s power to examine bank speculative activity in real estate did nothing to prevent the subprime crisis.

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greatly increased value of debts, which[,] therefore[,] led to more defaults and bankruptcies.” WESSEL, *supra* note 6, at 42 (citation omitted).

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

62. 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, 697 (1996) [hereinafter *Branching Restrictions*]. That insurance initially covered amounts up to \$2,500 and was increased to \$5,000 in 1935. *Id.* at 698. FDIC insurance was increased from \$100,000 per depositor to \$250,000 during the subprime crisis in 2008. David M. Herszenhorn, *Senate Approves Measure to Reduce Home Foreclosures*, N.Y. TIMES, May 7, 2009, at A4.

63. *Banking Restrictions*, *supra* note 62, at 697-98.

64. John A. Deangelis, *Riches Do Not Last Forever: Real Estate Investment by National Banks*, 1991 U. ILL. L. REV. 777, 783 (1991).

65. S. REP. NO. 73-77, at 7 (1933).

66. 12 U.S.C. §301 (2006).

### III. THE RISE AND FALL OF GLASS-STEAGALL

#### A. *Why Glass-Steagall?*

The Glass-Steagall Act of 1933<sup>67</sup> sought the “complete divorcement” of commercial and investment banking<sup>68</sup> 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.”<sup>69</sup> It is unclear from its legislative history why Congress mandated this divorce.<sup>70</sup> As one court noted:

When 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 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.<sup>71</sup>

There is little factual basis for concluding that the securities affiliates were a particular danger to banks. A study of nearly three

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67. Banking Act of 1933, ch. 89, Pub. L. No. 73-66, 48 Stat. 162 (codified as amended at scattered sections of 12 U.S.C.).

68. S. REP. NO. 73-1455, at 185 (1934) (Conf. Rep.).

69. TWENTIETH CENTURY FUND, INC., THE SECURITY MARKETS 84 (1935).

70. JIM POWELL, FDR'S FOLLY: HOW ROOSEVELT AND HIS NEW DEAL PROLONGED THE GREAT DEPRESSION 57-64 (2003).

71. *Sec. Indus. Ass'n v. Bd. of Governors of the Fed. Reserve 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). Numerous scholarly articles have been written on this issue. See Edmond M. Ianni, “Security” Under the Glass-Steagall Act and the Federal Securities Acts of 1933 and 1934: The Direction of the Supreme Court’s Analysis, 100 BANKING L. J. 100, 103-05 (1983) (discussing the perceived policy grounds behind the Glass-Steagall Act); Roberta Karmel, *Glass-Steagall: Some Critical Reflections*, 97 BANKING L. J. 631 (1980) (same); Casey K. McGarvey, *Federal Regulation of Bank Securities Activities: Will Congress Allow Glass-Steagall to be Shattered?* 12 J. CONTEMP. L. 99, 101-05 (1986) (same); Lawrence F. Orbe III, *Glass-Steagall: Lest We Forget*, 11 FLA. ST. U. L. REV. 163 (1983-1984) (same); Note, *A Conduct-Oriented Approach to the Glass-Steagall Act*, 91 YALE L.J. 102, 103-06 (1981) (same); Note, *Bankers Trust II: Underwriting, Commercial Paper Placement, and the Risk of Loss Under the Glass-Steagall Act*, 76 KY. L.J. 497, 504-507 (1987-1988) (same); Note, *Commercial Bank Private Placement Activity: Cracking Glass-Steagall*, 27 CATH. U. L. REV. 743, 747-50 (1977-1978) (same).

thousand banks that failed between 1865 and 1936 concluded that securities activities were not even among the top seven reasons for their failures.<sup>72</sup> 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.<sup>73</sup> 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.<sup>74</sup> 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."<sup>75</sup> However, that was an issue to be addressed at the bank level, not the securities affiliate level. To remedy that perceived problem, the Securities Exchange Act of 1934 gave the Federal Reserve Board the power to control bank lending on margin for stocks.<sup>76</sup>

Some think that the Glass-Steagall Act's prohibition on stock underwriting 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 was not shown to have caused the bank's failure. Rather, the bank's worst losses were due to its exposure to New York City real estate properties, which had plunged in value as the Great Depression began (half of the bank's loan portfolio was devoted to real estate finance).<sup>77</sup> 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.<sup>78</sup>

The actual reason for the Glass-Steagall Act proscriptions on investment banking appears to be the concern on the part of the Act's principal sponsor, Senator Glass, that the Federal Reserve Board had

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72. MARKHAM, *supra* note 34, at 168.

73. *Id.*

74. 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) (proposing that public awareness of the conflict of interest constrained commercial banks' opportunities for moral hazard).

75. *Sec. Indus. Ass'n*, 839 F.2d at 57.

76. 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 TEMP. L. REV. 59, 101-05 (1991).

77. AHAMED, *supra* note 53, at 386.

78. See JAMES GRANT, *MONEY OF THE MIND: BORROWING AND LENDING IN AMERICA FROM THE CIVIL WAR TO MICHAEL MILKEN* 203-10 (1992) (describing this failure).

created a speculative “investment banking system.”<sup>79</sup> 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.<sup>80</sup> 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 today, and it is because this bill would avert a repetition of that disaster that intense and bitter opposition has been organized against it.<sup>81</sup>

“Senator Glass’ aspiration to divorce completely commercial banks from their security affiliates was not attained” because the statute as enacted contained a number of exceptions for bank affiliate securities activities.<sup>82</sup> 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.<sup>83</sup> In any

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79. 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).

80. *Sec. Indus. Ass’n*, 839 F.2d at 57. A biography of Senator Glass that was published in 1939 fails to provide any elucidation on this issue. RIXEY SMITH & NORMAN BEASLEY, CARTER GLASS: A BIOGRAPHY (1939). Glass was a long-time critic of 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 would cause a drop in the value of bonds, which would hurt 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 182-84.

81. 76 CONG. REC. 2000 (daily ed. Jan. 18, 1933) (statement of Sen. Glass) (emphasis added).

82. *Sec. Indus. Ass’n*, 839 F.2d at 59.

83. See Jonathan Macy, *Special Interest Groups Legislation and the Judicial Function: The Dilemma of Glass-Steagall*, 33 EMORY L.J. 1, 2 (1984) (“[T]he actual motive behind the passage of the Act can only have been that of protecting one group—investment bankers—

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.<sup>84</sup>

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 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.<sup>85</sup> 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 encouraged them, taking an expansive view of the banking laws.<sup>86</sup> "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."<sup>87</sup>

Saxon's rulings allowing banks to intrude into other areas of commerce were occasionally subjected to legal challenges, and some of them were struck down by the courts.<sup>88</sup> Nevertheless, his successors in the OCC continued to interpret banking laws in ways that allowed banks to

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at the expense of another—commercial bankers.”)

84. LISSA L. BROOME & JERRY W. MARKHAM, REGULATION OF BANKING FINANCIAL SERVICE ACTIVITIES: CASES AND MATERIALS, 722 (3d ed. 2008).

85. Banks sometimes avoided Regulation Q ceilings by offering advertising premiums for new businesses and by offering toasters and other giveaways to attract depositors. HERBERT V. PROCHNOW & HERBERT V. PROCHNOW, JR., THE CHANGING WORLD OF BANKING 60 (1974). Regulation Q rates were repealed in order to allow banks to attract deposits at market rates. This led to rate competition and the growth of deposit brokers that placed funds with banks offering the highest rates. This was "hot money" that could be easily moved out of the banks, sometimes leading to what amounted to a run on a bank. This led to the imposition of restrictions allowing only "well-capitalized" banks to accept brokered deposits. More recently, in the wake of the subprime crisis, the FDIC has proposed to restrict the amount of interest that banks that are not well-capitalized can pay for deposits. Matthias Rieker, *For Banks, Rate Rules Could Mean Tough Times*, WALL ST. J., Nov. 6, 2009, at C1.

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

87. Comptroller of the Currency, Administrator of National Banks, James J. Saxon: Controller of the Currency, 1961-1966, <http://www.occ.treas.gov/saxon.htm> (last visited Mar. 28, 2010).

88. 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).

expand into areas that competed with other financial services firms.<sup>89</sup> The securities industry, which the investment bankers and their allies dominated, challenged a number of the expanded commercial bank activities authorized by the OCC.<sup>90</sup> In 1971, for example, the Supreme Court held in *Investment Company Institute v. Camp* that the operation by commercial banks of a commingled investment account violated the Glass-Steagall Act because it operated like a mutual fund.<sup>91</sup> 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.<sup>92</sup> Banks did subsequently operate mutual funds without such horrors arising.

Ten years after the *Camp* decision, the Supreme Court held, in *Board of Governors of Federal Reserve System v. Investment Co. Institute*,<sup>93</sup> 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.<sup>94</sup> In 1984, the Supreme Court held in *Securities Industry Association v. Board of Governors of the Federal Reserve Board* that commercial banks could not market commercial paper because it was a

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

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

91. 401 U.S. 617, 629 (1971).

92. *Id.* 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.

93. 450 U.S. 46, 71 (1981).

94. For a discussion of the inroads by banks into the securities business in the 1980s, see Thomas G. Fischer et al., *The Securities Activities of Commercial Banks: A Legal and Economic Analysis*, 51 *TENN. L. REV.* 467 (1984).

security under the Glass-Steagall Act.<sup>95</sup> However, that was a temporary setback because the District of Columbia Circuit Court subsequently held that a bank could distribute commercial paper on an agency basis, notwithstanding the prohibitions of the Glass-Steagall Act.<sup>96</sup>

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.<sup>97</sup> The Supreme Court upheld the Federal Reserve's approval of Bank America Corporation's acquisition of Charles Schwab in *Securities Industry Association v. Board of Governors of the Federal Reserve System*.<sup>98</sup> 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.<sup>99</sup>

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.<sup>100</sup> 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" securities like stock and corporate debt.<sup>101</sup> In 1988, the Second Circuit Court of Appeals 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

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95. 468 U.S. 137, 139-40 (1984).

96. *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. *Sanders v. John Nuveen & Co.*, 463 F.2d 1075 (7th Cir.), *cert. denied*, 409 U.S. 1009 (1972).

97. The Comptroller of the Currency determined in 1982 that the Security Pacific National Bank could operate a discount brokerage subsidiary. 2 JANE W. D'ARISTA, *THE EVOLUTION OF U.S. FINANCE, RESTRUCTURING INSTITUTIONS AND MARKETS* 311 (1994). 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. *Id.* at 77.

98. 468 U.S. 207, 221 (1984).

99. BankAmerica bought Schwab for \$55 million in 1983 and resold it to Schwab management in 1987 for \$280 million. Charles Schwab Corporation, *About Schwab: History*, <http://www.aboutschwab.com/about/history/index.html> (last visited Mar. 28, 2010).

100. Banking Act of 1933, Ch. 89, Pub. L. No. 73-66, § 16, 48 Stat. 162, 184-85 (codified as amended at 12 U.S.C. § 227 (1988)).

101. § 20, 48 Stat. at 189.

revenue.<sup>102</sup> That limit was increased to twenty-five percent in 1996, allowing some giant banks to acquire and operate some rather large broker-dealers.<sup>103</sup>

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,<sup>104</sup> but the Competitive Equality Banking Act of 1987 imposed a one-year moratorium on further approvals by the Fed for additional bank securities activities.<sup>105</sup> That only temporarily slowed the intrusion of the banks into the securities arena.

### B. Banking Intrusions

The Bank Holding Company Act prohibited bank holding companies from diversifying into non-traditional bank business without the Fed's approval.<sup>106</sup> That statute proscribed bank holding companies from holding shares of another company unless the Fed found the activities of such a company "to be so closely related to banking as to be a proper incident thereto."<sup>107</sup> Exempted from that provision were one-bank holding companies<sup>108</sup>—which became a popular way to avoid restrictions imposed on banks—until Congress eliminated that exception with the Bank Holding Company Act Amendments of 1970.<sup>109</sup> The amendments did, however, grandfather existing one-bank holding companies.<sup>110</sup> Reverse competition came in the form of non-bank banks. A non-bank bank did not meet the definition of a bank because they did not both accept deposits *and* make

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102. *Sec. Indus. Ass'n v. Bd. of Gov. of the Federal Res. Sys.*, 839 F.2d 47, 68-69 (2d Cir. 1988), *cert. denied*, 486 U.S. 1059 (1988).

103. *BROOME & MARKHAM*, *supra* note 84, 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. *Sec. Indus. Ass'n v. Bd. of Gov. of the Federal Res. Sys.*, 821 F.2d 810, 819-20 (D.C. Cir. 1987), *cert. denied*, 484 U.S. 1005 (1988).

104. *Am. Bankers Ass'n v. Sec. & Exch. Comm'n*, 804 F.2d 739, 755-56 (D.C. Cir. 1986).

105. Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, § 509(a), 101 Stat. 552, 635 (codified in scattered sections of 12 U.S.C. and 31 U.S.C.).

106. *D'ARISTA*, *supra* note 97, at 69.

107. 12 U.S.C. §1843(c)(8) (2006).

108. *Id.* § 1843(d).

109. Pub. L. No. 91-607, 84 Stat. 1760 (codified at 12 U.S.C. §§ 1850, 1971-78 (2006)); *see also* CHRISTOPHER ELIAS, *THE DOLLAR BARRONS* 162 (1973) (narrating the effect of the "loophole" on the banking industry and the story of its eventual removal).

110. § 2(5), 84 Stat. at 1761.

loans.<sup>111</sup>

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.<sup>112</sup> 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.<sup>113</sup> The Comptroller also allowed NationsBank to operate a subsidiary to develop residential condominiums.<sup>114</sup>

Several rulings by the Comptroller of the Currency and the Supreme Court permitted national banks to enter the insurance and annuities market.<sup>115</sup> Prior to these rulings, only certain state-chartered banks had been permitted to provide insurance services. The Garn-St. Germain Depository Institutions Act of 1982<sup>116</sup> sought to prohibit federal bank regulators from further expanding the powers of banks into underwriting insurance as an activity that is “integrally related to traditional bank functions.”<sup>117</sup> This precluded the Fed from authorizing bank holding companies to engage in or be affiliated with companies that were

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111. Several stock brokerage firms, including Merrill Lynch, operated non-banks, but Congress acted to curb such activities for non-bank banks not yet in existence through the Competitive Equality Banking Act of 1987. Pub. L. No. 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) (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 goods. 12 U.S.C. §1841(c)(2)(H). Target and Nordstrom were among the companies using this exemption. Eric Lipton, *Citing Risks, U.S. Seeks New Rules For Niche Banks*, N.Y. TIMES, Sept. 17, 2009, at A1. The Obama administration has claimed that these entities pose a systemic risk and is seeking their regulation. *Id.*

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

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

114. 3 JERRY W. MARKHAM, A FINANCIAL HISTORY OF THE UNITED STATES, FROM THE AGE OF DERIVATIVES INTO THE NEW MILLENNIUM (1970-2001) 241 (2002) [hereinafter MARKHAM II].

115. 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) (tracing the development of the banking industry, the insurance industry, and the regulations causing both their separation and overlap).

116. Pub. L. No. 97-320, 96 Stat. 1469.

117. Mattingly & Fallon, *supra* note 113, at 46 (describing the difficulty in resolving what specific functions should be exempted).

underwriting insurance, although the act grandfathered activities that had already been 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.<sup>118</sup> 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.<sup>119</sup> 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.<sup>120</sup> In 1995, the Supreme Court held that national banks could sell annuities.<sup>121</sup> One year later the Court ruled in *Barnett Bank of Marion County, N.A. v. Nelson* that the states could not enact legislation that would prevent national banks from participating in the insurance business.<sup>122</sup>

The Comptroller of the Currency had also ruled, in 1963, 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.<sup>123</sup> This action was taken under a statute that many people thought had been repealed in 1918.<sup>124</sup> 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.<sup>125</sup> After that decision, the OCC allowed banks to create operating subsidiaries that would operate a general insurance agency from a place with a population of 5,000 or less and use the nationwide branches of the bank for referrals.<sup>126</sup> The result of these inroads into the insurance industry was that some seventy percent of banks were offering some form of insurance

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118. *Indep. Bankers Ass'n of Am. v. Heimann*, 613 F.2d 1164, 1171 (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. *Indep. Ins. Agents of Am., Inc. v. Hawke*, 211 F.3d 638, 645-46 (D.C. Cir. 2000).

119. Leigh Rabemacher, *Powers of National Banks to Sell Insurance, Annuities and Securities from Bank Premises*, 30 CREIGHTON L. REV. 753, 754 (1997) (citations omitted).

120. MARKHAM II, *supra* note 114, at 241.

121. *NationsBank v. Variable Annuity Life Ins. Co.*, 513 U.S. 251, 264 (1995).

122. 517 U.S. 25, 43 (1996).

123. *Indep. Ins. Agents of Am. v. Ludwig*, 997 F.2d 958 (D.C. Cir. 1992).

124. Pub. L. No. 64-270, ch. 461, 39 Stat. 752, 753-54 (1916); *see also* David W. Roderer, *Nonexistent Banking Law Warrants Close Scrutiny*, LEGAL TIMES, Jan. 19, 1984, at 12 (describing this incident).

125. *U.S. Nat'l Bank of Or. v. Indep. Ins. Agents of Am.*, 508 U.S. 439, 463 (1993).

126. O.C.C. Interpretative Letter 753, to Robert L. Andersen, Esquire, Senior Vice President and Assistant Gen. Counsel (Nov. 4 1996), *available at* 1996 WL 655026.

product before enactment of the Gramm-Leach Bliley Act.<sup>127</sup> Banks were then accounting for over twenty-five percent of annuity sales.<sup>128</sup>

Despite the Supreme Court's decision in *Investment Company Institute v. Camp*,<sup>129</sup> by 1993 banks had also become one of the largest sellers of mutual funds,<sup>130</sup> a product regulated by the SEC under the Investment Company Act of 1940.<sup>131</sup> 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 their customers with respect to mutual funds. Banks offered "private label" mutual funds as well as those of other organizations.<sup>132</sup>

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.<sup>133</sup> 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.<sup>134</sup>

### C. *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

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127. CLIFFORD E. KIRSCH, *THE FINANCIAL SERVICES REVOLUTION: UNDERSTANDING THE CHANGING ROLE OF BANKS, MUTUAL FUNDS, AND INSURANCE COMPANIES* 85 (1997).

128. BROOME & MARKHAM, *supra* note 84, at 879.

129. 401 U.S. 617, 625 (1971) (finding that investment fund operation violated the Glass-Steagall prohibition on issuance, sale, and distribution of securities).

130. See Penny Lunt, *How Are Mutual Funds Changing Banks?*, A.B.A. BANKING J., June 1993, at 31 (quoting James Shelton's statement that "[b]anks will soon become the major source of distribution for mutual fund products").

131. Investment Company Act of 1940, ch. 686, 54 Stat. 789 (codified at 15 U.S.C. 80a-1 *et seq.* (2006)).

132. MARKHAM II, *supra* note 114, at 239.

133. *Id.*

134. *Id.* at 239-40.

increasingly important as advances in technology and telecommunications accelerate the rate of change.<sup>135</sup>

The Comptroller's Office adopted a statement by a court in which it was asserted: "[W]e believe the powers of national banks must be construed so as to permit the use of new ways of conducting the very old business of banking."<sup>136</sup> 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."<sup>137</sup> Banks were underwriting and distributing loans and bonds, providing mezzanine financing to companies, engaging in foreign exchange trading in the interbank currency market, advising customers on mergers and acquisitions, and offering complex financial instruments.<sup>138</sup> 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.<sup>139</sup> 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.<sup>140</sup>

Before GLBA, many of the larger banks were receiving from one-third to over half of their revenues from non-interest income. Some of the activities that the banking regulators found to be closely related to banking included: 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 accounts and cash management services; providing tax planning and preparation services; operating an agency for

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135. *Id.* at 140 (quoting Letter from OCC, to Margery Waxman, Sidley & Austin (July 23, 1987)).

136. *Id.* (quoting Letter from OCC, to Margery Waxman, Sidley & Austin (July 23, 1987) (quoting *M & M Leasing Corp. v. Seattle First Nat'l Bank*, 563 F.2d 1377, 1382 (9th Cir. 1977), *cert. denied*, 436 U.S. 956 (1978)).

137. Timothy L. O'Brien, *Chase's Global Pit Boss: Executive Leads Bank into High-Stakes Markets*, N.Y. TIMES, Jan. 16, 1998, at D1.

138. Markham, *supra* note 86, at 250-51 (citations omitted). The banks were occasionally stymied by the courts in offering new products; *see, e.g.*, *Blackfeet Nat'l Bank v. Nelson*, 171 F.3d 1237, 1244 (11th Cir.), *cert. denied*, 528 U.S. 1004 (1999) (noting that banks could not underwrite retirement CDs).

139. *Blackfeet Nat'l Bank*, 171 F.3d at 1244.

140. *Id.*; *see also* MICHAEL G. CAPATIDES, A GUIDE TO CAPITAL MARKETS ACTIVITIES OF BANKS AND BANK HOLDING COMPANIES 185-86 (1993) (explaining these bank and bank affiliate activities); Jerry W. Markham & David J. Gilberg, *Federal Regulation of Bank Activities In the Commodities Markets*, 39 BUS. LAW. 1719, 1722 (1984) (describing such activities further).

collecting overdue accounts receivable; and operating a credit bureau.<sup>141</sup>

*D. Gramm-Leach-Bliley*

The banks 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.<sup>142</sup> 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 a provision for three one-year extensions by the Fed.<sup>143</sup>

Citigroup took a gamble, assuming that this merger would incentivize Congress to act in order to avoid breaking up the Travelers Group. It worked. The merger occurred on April 6, 1998 and the Glass-Steagall Act was repealed by the Gramm-Leach-Bliley Act (“GLBA”) on November 12, 1999.<sup>144</sup> Among other things, the GLBA removed insurance underwriting restrictions on commercial banks.<sup>145</sup> It also repealed section 20 of the Glass-Steagall Act, thus allowing commercial banks to create “financial holding companies” and “financial subsidiaries.” These entities can provide any number of services, as long as they are “financial in

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141. See MARKHAM II, *supra* note 114, at 238 (explaining the activities that led to revenues from non-interest income).

142. For a description of the merger see CIT Group, Inc. v. Citicorp, 20 F. Supp. 2d 775, 784 (D.N.J. 1998).

143. 12 U.S.C. §1842(a) (2006).

144. Gramm-Leach-Bliley Act of 1999, Pub. L. No. 106-102, 1999 U.S.C.A.N. (113 Stat.) 1338; see also Michael Schroeder, *Congress Passes Financial Services Bill*, WALL ST. J., Nov. 5, 1992, at A2 (“By stripping away restrictions in the Glass-Steagall financial-services law—which prohibited the mixing of banking, securities and insurance activities—the overhaul is a windfall for financial industries.”). One critic of the GLBA asserted that Robert Rubin, while Secretary of the Treasury in the Clinton administration, shepherded GLBA through Congress for the benefit of Citigroup, where he became a senior executive after leaving the Treasury. CHARLES GASPARINO, *THE SELLOUT* 190 (2007). There is little doubt that the passage of GLBA was partially motivated by a desire to allow Citicorp to merge with the Travelers group of insurance companies, which had insurance underwriting operations that were prohibited by Glass-Steagall. See Andrew Martin & Gretchen Morgenson, *Can Citigroup Carry Its Own Weight?*, N.Y. TIMES, Nov. 1, 2009, at BU1 (“In trying to right itself, Citigroup plans to undo much of what it did during a period some insiders call the lost decade—with events that included merging with Travelers Group in 1998.”). If GLBA had not been enacted, the renamed Citicorp would have had to sell those operations. Ironically, Citicorp sold those underwriting operations anyway before the subprime crisis arose. Eric Dash, *MetLife to Buy Insurance Unit From Citigroup*, N.Y. TIMES, Feb. 1, 2005, at C1; *Travelers Reports a Quarterly Profit*, N.Y. TIMES, Oct. 17, 2002, at C8.

145. 12 U.S.C. §1843(k)(4)(B).

nature”—even when those services constitute investment banking.<sup>146</sup> The banks underwriting operations were 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 surpassed Merrill Lynch as the nation’s largest underwriter of stocks and bonds.<sup>147</sup>

The GLBA opened the door for commercial banks to enter other areas of finance, including, among other things, engaging freely in commercial paper dealings<sup>148</sup> and making limited merchant banking investments.<sup>149</sup> The issue now to be considered is whether the repeal of Glass-Steagall by the GLBA somehow allowed the banks to engage in the activities that nearly destroyed them during the subprime crisis.

### E. *The Subprime Crisis*

The subprime crisis was, without a doubt, 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 had been securitized and those offerings 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. Congress passed a \$700 billion bailout package in October 2008, called the Troubled Asset Recovery Program (“TARP”), to inject capital into financial institutions, including \$25 billion into Citigroup and \$173 million at AIG.<sup>150</sup>

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146. See, e.g., Adam Nguyen & Matt Watkins, *Financial Services Reform*, 37 HARV. J. ON LEGIS. 579, 579 (2000) (“An understanding of the significance of the Gramm-Leach-Bliley Act requires a brief examination of the inception of the Glass-Steagall Act and the BHCA.”); Paul J. Polking & Scott A. Cammarn, *Overview of Gramm-Leach-Bliley*, 4 N.C. BANKING INST. 1, 1 (2000) (“The Act makes sweeping changes to federal statutes governing the scope of permissible activities and the supervision of banks, bank holding companies, and their affiliates.”); 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) (discussing the “firewall” limitation imposed by the Glass-Steagall Act).

147. See Randall Smith, *Citigroup Unseats Merrill Lynch as Busiest Underwriter*, WALL ST. J., Dec. 28, 2001, at C1 (“Citigroup Inc. has dislodged Merrill Lynch & Co. as Wall Street’s biggest underwriter of stocks and bonds.”).

148. BROOME & MARKHAM, *supra* note 84, at 795.

149. 12 U.S.C. §1843(k)(4)(H) (2006).

150. For a description of those events see WESSEL, *supra* note 6, *passim*. The subprime crisis had other ripple effects. The Dow Jones Industrial average fell forty-seven percent on February 19, 2009 from the October 1, 2007 high of 14,087. See E.S. Browning, *Market Hits New Crisis Low*, WALL ST. J., Feb. 20, 2009, at A1 (“The Dow industrials now have

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 income and creditworthiness. Credit quality did not concern the mortgage brokers and lenders making those loans because the loans were immediately securitized in a pool and then resold to investors as a collateralized debt obligation (“CDO”).<sup>151</sup>

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”).<sup>152</sup> Those protections allowed the “Super Senior”

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lost nearly half their value, or 47%, since their record close 16 months ago.”). This devastated retirement savings, college and other endowments and, presumably, every other investor in the market. *Id.*

151. For a description of the subprime mortgage market see MUOLO & PADILLA, *supra* note 111.

152. 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.

tranches in subprime securitizations to obtain 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”). 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. These carry trade programs were flawed, however. 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, eliminating the spread, or even inverting the payment stream.<sup>153</sup>

#### F. 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 the 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, the *Times* attacked Senator Phil Gramm, one of the sponsors of the GLBA, as having opened the door to the subprime crisis by deregulating a host of financial services.<sup>154</sup> Among other things, the article 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 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.<sup>155</sup>

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UBS AG, SHAREHOLDER REPORT ON UBS'S WRITE-DOWNS § 4.2.2, at 13 (Apr. 18, 2008).

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

154. See Eric Lipton & Stephen Labaton, *A Deregulator Looks Back, Unswayed*, N.Y. TIMES, Nov. 17, 2008, at A1 (“[I]n one remarkable stretch from 1999 to 2001, he pushed laws and promoted policies that he says unshackled businesses from needless restraints but his critics charge significantly contributed to the financial crisis that has rattled the nation.”).

155. *Id.* Editor’s Note: The Dodd-Frank Wall Street Reform and Consumer Protection Act that was passed on July 15, 2010 adopted a modified version of the Volcker Rule. Title

The *Times* further charged Gramm with creating (through other legislation that was enacted in 2000) a loophole that allowed credit default swaps, which destroyed AIG, to trade unregulated.<sup>156</sup> Gramm was unrepentant. He blamed the crisis on faulty monetary policy and the politicization of mortgage lending.<sup>157</sup>

Another critic of the GLBA was former Fed Chairman Paul Volcker who served as the head of President Barack Obama's Economic Recovery Advisory Board. Volcker advocated that commercial banking activities should be separated from investment banking and that commercial banks should not be allowed to own or trade "risky" securities.<sup>158</sup> Volcker was initially unsuccessful in convincing the Obama administration to adopt such an approach.<sup>159</sup> Fed Chairman Ben Bernanke, on the other hand, urged a "more subtle approach."<sup>160</sup> Nevertheless, Volcker's proposal was supported by Mervyn King, Governor of the Bank of England.<sup>161</sup> A form of "narrow banking" was proposed by Senator John McCain—the former Republican presidential candidate—and Democratic Senator Maria Cantwell who jointly sponsored a bill in December 2009 that would restore Glass-Steagall's dividing line between investment and commercial banking.<sup>162</sup> However, one unnamed Treasury official was reported as

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VI, § 619 allows banks to invest up to 3 percent of their Tier 1 capital in hedge funds and private equity funds. Such investments may not exceed 3 percent of the assets of the hedge fund or private equity group in which an investment is made.

156. *Id.*

157. Phil Gramm, *Deregulation and the Financial Panic*, WALL ST. J., Feb. 20, 2009, at A17.

158. Banks have long been attacked for taking on too much risk, but as Walter Wriston, the former head of Citibank, noted in a book published in 1986, that business, and society itself, advances only through risk taking. WALTER B. WRISTON, *RISK & OTHER FOUR LETTER WORDS passim* (1986).

159. See Louis Uchitelle, *Volcker's Voice, Often Heeded, Fails to Sell a Bank Strategy*, N.Y. TIMES, Oct. 21, 2009, at A1 (noting that Volcker "wants the nation's banks to be prohibited from owning and trading risky securities, the very practice that got the biggest ones into deep trouble in 2008," but that administrators refuse to "separate commercial banking from investment operations").

160. See Stephen Labaton, *Trying to Rein in "Too Big to Fail" Institutions*, N.Y. TIMES, Oct. 26, 2009, at A1 ([Bernanke] would prefer "a more subtle approach without losing the economic benefit of multifunction, international firms."). 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 (discussing the government's options going forward in order to prevent another too big to fail crisis).

161. Labaton, *supra* note 160, at A1.

162. Edward Luce, *US Reformers Look Back to the Future*, FIN. TIMES (London), Dec. 19-20, 2009, at 2. Robert E. Litan, a senior fellow at the Brookings Institution, proposed the concept of "narrow banking," or "safe banking" as it is sometimes called, in a book published in 1987, more than a decade before the enactment of GLBA. ROBERT E. LITAN, *WHAT SHOULD BANKS DO?* (1987). Litan advocated dividing banks into separate entities, one of which would be a narrow bank that would only take government deposits and invest in U.S. government securities; other business would be prohibited. *Id.* The second entity

saying that bringing back Glass-Steagall “would be like going back to the Walkman.”<sup>163</sup>

U.S. Treasury Secretary Timothy Geithner initially took another approach. He advocated granting bank regulators the power to order large financial firms—even healthy ones—to sell off assets if their size threatened the economy.<sup>164</sup> This proposal represented a sort of tailored Glass-Steagall approach. European regulators already forced large financial institutions that were bailed out during the subprime crisis to sell off non-core operations. The European Union required such divestments as a condition for state-sponsored bailouts. For example, the EU required the Royal Bank of Scotland to sell its profitable insurance operations, a commodity-trading unit, and a payment services firm.<sup>165</sup> The British government broke up Northern Rock, the bank that was nationalized during the subprime crisis as a result of subprime exposures, into a “good” bank and a “bad” bank, such that assets could be sold.<sup>166</sup> Similarly, the Dutch government ordered the ING Group to be broken up after a \$14.9 billion bailout.<sup>167</sup>

On January 21, 2009, President Obama finally resolved the impasse in his administration regarding the revival of Glass-Steagall. He announced that large banks would be limited in size, barred from trading for their own accounts, and barred from operating hedge funds or private equity programs.<sup>168</sup> This Paul Volcker-inspired measure shook the stock market

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would essentially be banks in their present post-GLBA form, which would be allowed to deal freely in investment and commercial banking activities, except deposits would not have FDIC insurance. *Id.* Litan complained that banking lawyers had “created ‘virtually a cottage industry in the discovery and exploitation of loopholes in the [Glass-Steagall] act that render its intended restrictions less and less relevant to the marketplace.’” George Melloan, *Business World: The Efficiency Argument for Banking Reform*, WALL ST. J., Dec. 29, 1987, at 15 (quoting Robert E. Litan, *Reuniting Investment and Commercial Banking*, 7 CATO J. 803, 803 (1988)).

163. Thomas Frank, *Bring Back Glass-Steagall*, WALL ST. J., Jan. 10, 2010, at A21.

164. See Damian Paletta, *U.S. Seeks Power to Force Even Strong Banks to Shrink*, WALL ST. J., Oct. 30, 2009, at A8 (reporting on Timothy Geithner’s proposal to overhaul banking rules).

165. Charles Forelle & Sara Munoz, *EU Sheds Soft Touch for Iron Fist on Banks*, WALL ST. J., Nov. 4, 2009, at C1.

166. See Sharlene Goff, *Brussels Agrees N Rock Break-up and Sale*, FIN. TIMES (London), Oct. 29, 2009, at 8 (reporting the restructuring of Northern Rock into “good” and “bad” banks).

167. 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 (noting ING’s near collapse “under a mountain of troubled American mortgage assets”).

168. Jonathan Weisman, et al., *New Bank Rules Sink Stocks*, WALL ST. J., January 21, 2010, at A1. The proposed ban on proprietary trading would have doubtful effects since many of the larger banks had already curtailed those activities. Kate Kelly, *Banks Gear Up For Battle*, WALL ST. J., Feb. 2, 2010, at C1. It was also unclear whether this restriction

when it was announced.<sup>169</sup> It seemed to have been passed as a result of politics rather than economics,<sup>170</sup> and it begged the issue of whether the repeal of Glass-Steagall had contributed to the subprime crisis by opening the door to the mortgage-backed securities that were at the center of the storm.

#### IV. THE DEVELOPMENT OF MORTGAGE-BACKED BONDS

##### A. *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 existed for a long time, and proved to be problematic on more than one occasion. The mortgage-backed security concept came 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.”<sup>171</sup>

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

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would apply to hedge trades used to protect the banks from customer-associated risks. *Id.* Volcker was reported to be soft-pedaling his prior proposal to completely restore the Glass-Steagall restrictions, instead opting for a more limited form of that legislation. Rachele Younglai & Kevin Drawbaugh, *Big Banks' Risky Trading Should Be Curbed: Volcker*, REUTERS, Feb. 1, 2010, <http://www.reuters.com/article/idUSTRE6110EZ20100202>.

169. Javier C. Hernandez, *Obama's Bank Proposal Helps Erase the Month's Gains*, N.Y. TIMES, Jan. 22, 2010, at B6.

170. President Obama went on a rampage against Wall Street in January 2010. See Jackie Calmes, *With Populist Stance, Obama Takes on Banks*, N.Y. TIMES, Jan. 22, 2010, at A1 (discussing President Obama's toughened approach to financial regulation). He first announced plans for a tax on the large banks that would fund the bailout. *Id.* He then flew to Boston to bash the banks in support of a Senate race for the seat left open by Ted Kennedy's death. *Id.* That effort failed, giving the Republicans enough votes to initially block the administration's health care bill. *Id.* This angered the President, and he announced his plan to partially revive Glass-Steagall two days later. *Id.*

171. Kenneth Snowden, *What Can History Tell Us About the Crisis in Mortgage Securitizations?*, FIN. HIST. MAG. (Museum of Am. Fin., New York, N.Y.), Winter 2003, at 16, 16. A preliminary report by the European Union rejected the Volcker proposal. Joe Kirwin, *EU Finance Ministers to Hold Special Meeting to Consider New Obama Proposals for Banks*, 42 SEC. REG. & L. REP. (BNA) 295 (Feb. 22, 2010).

mortgages they were selling.<sup>172</sup> 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.<sup>173</sup> Debentures that were collateralized by the mortgages held in trust were then sold, 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" that were calling in their loans.<sup>174</sup> 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.<sup>175</sup>

In 1904, New York State authorized property title insurance companies to insure mortgage payments; the business of guaranteeing mortgages was an outgrowth of the title insurance business.<sup>176</sup> 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 pooled and placed in trust, and interests in that trust were sold to investors as undivided shares in the pool in the form of collateral trust certificates. "By 1913 some of these companies also placed mortgage loans in trust, insured the payments on these loans, and sold participation certificates in these mortgages."<sup>177</sup> These certificated mortgages could cover a single large commercial mortgage, a form of syndication, or a group of small residential loans, and they could be packaged in ways similar to modern forms of securitization.

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 \$0.5 to nearly \$3 billion; \$0.8 billion of this total was written on certificated mortgages."<sup>178</sup> The Bond & Mortgage Guarantee Company guaranteed mortgages sold to investors by the Title Guarantee & Trust Company. It guaranteed more than \$2 billion of mortgages that were sold

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172. Snowden, *supra* note 171, at 17.

173. For a description of the Farmers' Loan & Trust Co., see *Pollock v. Farmers' Loan & Trust Co.*, 157 U.S. 429, 430-31 (1895) (describing allegations in the bill of the plaintiff, Charles Pollock, regarding the company's profits and investment income in 1894).

174. See *Watkins Land Mortgage Co.'s Failure*, N.Y. TIMES, Apr. 8, 1894, at 13 (citing a statement by the receiver, J.B. Watkins, that nervousness of investors had led to the receivership).

175. Snowden, *supra* note 171, at 17.

176. *Id.* at 18.

177. *Id.*

178. *Id.*

to savings banks and other investors.<sup>179</sup> This was the precursor of the monoline insurance companies that would eventually be at the center of the subprime crisis in 2007.

*B. 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 \$1,000 that entitled them to participate in 122 different mortgages.<sup>180</sup> 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.

S.W. Straus & Co. offered 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 six 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.”<sup>181</sup> Mortgage bonds were 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. These real estate bonds were often supported by unreliable appraisals of the property, and problems associated with the properties were frequently undisclosed.<sup>182</sup>

Difficulties arose in 1926, when a real estate bond in Florida defaulted during a market downturn in the state, and 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, and it joined other real estate bond firms as targets of an investigation by the New York State Attorney General and by a committee of the American Construction Council, headed by Franklin D. Roosevelt.<sup>183</sup>

Another failure was the New York Real Estate Securities Exchange,

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179. MARKHAM, *supra* note 34, 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 (reporting on the company’s gross receipts, net earnings and profit and loss surplus in 1921).

180. MARKHAM, *supra* note 34, at 147.

181. JAMES GRANT, *MONEY OF THE MIND: BORROWING AND LENDING IN AMERICA FROM THE CIVIL WAR TO MICHAEL MILKEN* 161 (1992).

182. MARKHAM, *supra* note 34, at 147.

183. GRANT, *supra* note 181, at 168.

which opened on October 1, 1929.<sup>184</sup> 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. The Stock Market Crash of 1929 occurred less than a month later, and the new exchange failed.<sup>185</sup>

In the 1920s, the New York State Department of Insurance regulated the mortgage guarantee companies.<sup>186</sup> In 1933, as those companies began defaulting, the department halted further mortgage guarantees, and took control of eighteen companies engaged in the business of guaranteeing and selling mortgages and mortgage certificates.<sup>187</sup> The Moreland Act of 1907 authorized the New York governor to appoint a “Moreland commissioner” to investigate a broad range of activities.<sup>188</sup> 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.<sup>189</sup> Ironically, Lehman was the son of one of the founders of the Lehman Brothers investment-banking firm, which would later 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.<sup>190</sup>

The House of Representatives appointed a “Select Committee” to investigate real estate bondholders’ reorganizations in 1934, following a protest by 10,000 defaulted mortgage 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.<sup>191</sup>

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184. MARKHAM, *supra* note 34, at 147.

185. *Id.* at 169-70.

186. Snowden, *supra* note 171, at 18.

187. *Id.*

188. N.Y. EXEC. LAW § 6 (McKinney 1982).

189. GEORGE W. ALGER, REPORT OF THE MORELAND COMMISSIONER 3 (Oct. 5, 1934).

190. *Id.* The Moreland commissioner found that mortgage bonds were often backed, in whole or in part, by vacant land that produced no income. *Id.* The commissioner also found that appraisals were often out of date and based on prices that had sharply declined. *Id.* In some instances, appraisal figures were determined by simply multiplying the amount of the loan by 150 percent, the statutory minimum, without any inspection of the property. *Id.* Many properties on which mortgage bonds were sold in 1932 and 1933 were already in default when sold to investors. David Saperstein, Director, Trading and Exchange Division, Address Before the National Mortgage Board of the National Association of Real Estate Boards: Real Estate Bond Issues of the Future (Oct. 23, 1935).

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

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,” which were formed ostensibly to protect the interests of defaulted mortgage bond owners, but were fraught with abuse, charging excessive fees and expenses.<sup>192</sup> Over 10,000 protective committees 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.<sup>193</sup> The Chandler Act was repealed in 1978.<sup>194</sup>

### C. Government-Sponsored Enterprises

The Great Depression caused 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 financial institutions in the country.”<sup>195</sup> 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.<sup>196</sup> At one point, mortgages were being foreclosed at a rate of 1,000 per day.<sup>197</sup> “By 1933 the mortgage market had effectively ceased to function.”<sup>198</sup> “Between 1929 and 1933, the stock of mortgage loans

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192. *Id.*

193. *Id.*

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

195. WILLIAM E. LEUCHTENBURG, FRANKLIN D. ROOSEVELT AND THE NEW DEAL: 1932-1940, 39 (1963). 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.” FEDERAL HOUSING ADMINISTRATION, THE FHA STORY IN SUMMARY 1 (1959).

196. 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, 239 (2005).

197. *Id.*

198. BARRY P. BOSWORTH ET AL., THE ECONOMICS OF FEDERAL CREDIT PROGRAMS 48 (1987). 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

declined fifteen percent and housing construction dropped eighty percent.”<sup>199</sup>

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.<sup>200</sup> The Home Owners Loan Act of 1933 created the Home Owner’s Loan Corporation (“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.<sup>201</sup> The National Housing Act of 1934 created the Federal Housing Administration (“FHA”) to insure residential mortgages against default, a mission that it continues to carry out today.<sup>202</sup>

Another Depression era agency, the Reconstruction Finance Corporation (“RFC”), created the National Mortgage Association in 1938. That entity’s name was quickly changed to the Federal National Mortgage Association and is now universally referred to as “Fannie Mae.” The Federal National Mortgage Association 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 these 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.<sup>203</sup>

Congress re-chartered Fannie Mae in 1968 as 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 homeownership for low-

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beyond their capacity to bear and thus swelled the volume of foreclosures, increased the fluctuations in real estate values, and destroyed the homeownership 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).

199. BOSWORTH, *supra* note 198, at 48.

200. 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 198, at 488.

201. HOLC spent \$3.1 billion to refinance mortgages on more than one million homes between 1933 and 1936. MARKHAM, *supra* note 34, at 172.

202. *Id.*

203. Wright, *supra* note 196, at 259.

moderate-, and middle-income Americans.”<sup>204</sup> Reaching that goal caused Fannie Mae to fail during the subprime crisis.<sup>205</sup> 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.<sup>206</sup> A credit crunch occurred in 1966 that curbed mortgage lending and sharply reduced housing starts.<sup>207</sup> Things seemed to have gotten better in 1967, but another credit crunch hit in 1968.<sup>208</sup> The Housing and Urban Development Act of 1968 created the Government National Mortgage Association (“Ginnie Mae,” sometimes also called “GNMA”).<sup>209</sup> Ginnie Mae did not itself 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, or other government-sponsored programs that were encouraging broader access to credit by particular segments of society.<sup>210</sup>

In 1969, interest rates reached historic levels, further reducing mortgage lending.<sup>211</sup> The Emergency Home Finance Act of 1970 was passed to relieve this situation.<sup>212</sup> 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, Freddie Mac also had an implicit government guarantee, and it too would fail during the subprime crisis.

#### D. *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 at some time in the future. An early example of securitization was found in Amsterdam in the seventeenth century.<sup>213</sup>

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204. 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).

205. ANDREW ROSS SORKIN, *TOO BIG TO FAIL* 182-185 (2009).

206. Richard W. Bartke, *Fannie Mae and the Secondary Mortgage Market*, 66 NW. U. L. REV. 1 (1971).

207. *Id.*

208. *Id.*

209. PETER CHINLOY, *REAL ESTATE: INVESTMENT AND FINANCIAL STRATEGY* 216 (1988).

210. Christopher L. Peterson, *Predatory Structured Finance*, 28 CARDOZO L. REV. 2185, 2198-99 (2007).

211. Bartke, *supra* note 206, at 48.

212. Pub. L. No. 91-351, § 303(a), 84 Stat. 450, 452 (codified as amended at 12 U.S.C. § 1452 (2006)).

213. WILLIAM J. BERNSTEIN, *A SPLENDID EXCHANGE: HOW TRADE SHAPED THE WORLD* 235-36 (2008).

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.<sup>214</sup> By pooling the securities, the *zielkoopers* were able to diversify their risks. However, a rising mortality rate for the sailors bankrupted many of these merchants. Subprime lenders would have a similar experience in this century.<sup>215</sup>

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.<sup>216</sup> 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.<sup>217</sup> 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.<sup>218</sup> 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.<sup>219</sup> This payment stream raised some complex yield issues and reinvestment concerns.<sup>220</sup>

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 has to reinvest those funds. If interest rates had dropped

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214. *Id.*

215. *Id.*

216. Eduardo F. Rodriguez, 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); see also About Ginnie Mae: The Pioneer of Mortgage-Backed Securities, <http://www.ginniemae.gov/about/history.asp?subTitle=About> (last visited Mar. 29, 2010) (discussing how Ginnie Mae “revolutionized the American housing industry in 1970 by pioneering the issuance of mortgage-backed securities.”).

217. Rodriguez, *supra* note 215, at 147

218. *Id.*

219. MARKHAM II, *supra* note 114, at 143.

220. *Id.*

since the purchase of the pass-through certificate, then reinvestment would have to be made at the then-existing lower interest rate, which would displease the certificate holder. This creates a reinvestment risk. Because of this repayment feature, pass-through securities do not react in the same manner as corporate bond prices when interest rates fall. 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.<sup>221</sup>

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”).<sup>222</sup> The CMO was a product that was created for Freddie Mac, in 1983, by Larry Fink, who was then working at First Boston Corporation.<sup>223</sup> Fink went on to head BlackRock Inc., a giant asset manager, and played a prominent role in managing distressed pooled mortgage assets during the subprime crisis.<sup>224</sup>

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 an investment 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.

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 an event, homeowners will be reluctant to sell their homes or to

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221. *Id.*

222. John C. Cody, Comment, *The Dysfunctional “Family Resemblance” Test: After Reves v. Ernst & Young, When are Mortgage Notes “Securities”?*, 42 BUFF. L. REV. 761, 784 (1994).

223. Katrina Booker, *Can this Man Save Wall Street?*, FORTUNE, Nov. 10, 2008, at 102.

224. *Id.*

refinance them because they will have to pay a higher interest rate on a new mortgage. This means that the certificate holder will be locked in for a longer than predicted period of time, causing a drop in the value of the certificate because the certificate holder will be receiving a lower rate than what prevails in the market for a longer-than-predicted time.<sup>225</sup>

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.<sup>226</sup> 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.<sup>227</sup> This problem presaged the valuation issues that would emerge during the subprime crisis in 2007.

## V. GLASS-STEAGALL AND BANK SECURITIZATIONS

### A. *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.’”<sup>228</sup> 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.<sup>229</sup> In addition, in 1984, Congress passed the Secondary Mortgage Market Enhancement Act (“SMMEA”),<sup>230</sup> seeking to allow “private issuers of mortgage securities to compete effectively with

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225. 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. MORRIS, *supra* note 153, at 39-41.

226. MORRIS, *supra* note 153, at 42.

227. MARKHAM II, *supra* note 114, at 144.

228. Jennifer Cummins, *Historical Changes Within the Credit and Investment Markets, in Developments in Banking and Financial Law 2006-2007: The Subprime Mortgage Crisis*, 27 REV. BANKING & FIN. L. 21, 26 (2008) (quoting Peterson, *supra* note 210, at 2200).

229. Pub. L. No. 97-320, 96 Stat. 1510 (codified at 12 U.S.C. § 371(a) (2006)).

230. Pub. L. No. 98-440, 98 Stat. 1689 (codified at 12 U.S.C. § 24 (2006)).

government-related agencies, which had come to dominate the market, by removing some of the legal impediments to issuing private mortgage-backed securities.”<sup>231</sup>

In *Securities Industry Ass’n v. Clarke*,<sup>232</sup> the Second Circuit upheld a 1987 determination by the OCC that the Glass-Steagall Act did not bar a national bank from selling mortgage-backed securities.<sup>233</sup> The Court recognized that national banks have long been viewed to have the incidental power to sell mortgages.<sup>234</sup> It stated:

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.<sup>235</sup>

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.<sup>236</sup> 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.

### B. 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

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231. Cummins, *supra* note 228, at 26; *see also* KENNETH G. LORE, MORTGAGE-BACKED SECURITIES: DEVELOPMENTS AND TRENDS IN THE SECONDARY MORTGAGE MARKET 1-22 (1994) (providing brief overview of the SMMEA and noting its purpose to “expand significantly the role of the private sector . . . in this expanding credit market”).

232. 885 F.2d 1034 (2d Cir. 1989), *cert. denied*, 493 U.S. 1070 (1990).

233. 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” and that they lacked the authority to issue, underwrite, or deal in third-party CMOs. Susan M. Golden, Comment, *Collateralized Mortgage Obligations: Probing the Limits of National Bank Powers Under the Glass-Steagall Act*, 36 CATH. U. L. REV. 1025, 1030 (1987).

234. *Clarke*, 885 F.2d at 1044 (citing *First Nat’l Bank v. City of Hartford*, 273 U.S. 548, 560 (1927)) (acknowledging that the Comptroller relied on three bases for determining that banks have such authority).

235. *Clarke*, 885 F.2d at 1049.

236. MARKHAM II, *supra* note 114, at 240.

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) those with no credit history; and (3) borrowers who have existing credit but who are overextended.<sup>237</sup> FICO credit scores are also used to identify subprime borrowers.<sup>238</sup>

To avoid losses from risky subprime loans, large banks traditionally “redlined” areas of the communities where subprime borrowers lived, and refused to make mortgage loans in those areas.<sup>239</sup> Minorities were often concentrated in the redlined areas, and this practice came to be viewed as racially discriminatory.<sup>240</sup> In order to stop the practice of redlining, Congress enacted the Home Mortgage Disclosure Act of 1975 (HMDA), which required banking institutions in metropolitan areas to disclose their mortgage loans by classification and geographic location, under the assumption that such disclosures would reveal discriminatory lending patterns.<sup>241</sup>

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237. Evan M. Gilreath, Note, *The Entrance of Banks Into Subprime Lending: First Union and the Money Store*, 3 N.C. BANKING INST. 149, 150-51 (1999).

238. As one court noted:

[M]ost 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.

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 Fin. Corp. Sec. Litig.*, 588 F. Supp. 2d 1132, 1146-47 (C.D. Cal. 2008) (citations omitted).

239. 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) (providing a detailed description of the history and evolution of the FHA).

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

241. Home Mortgage Disclosure Act of 1975, Pub. L. No. 94-200, 89 Stat. 1125

The Community Reinvestment Act (“CRA”) of 1977 went a step further, requiring affirmative action by banks in meeting the credit needs of minorities in their service areas.<sup>242</sup> The CRA made loaning to subprime areas a statutory condition for receiving approval from bank regulators for bank mergers.<sup>243</sup> The CRA had little immediate effect until restrictions on bank branching and interstate mergers were eased. In particular, the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994<sup>244</sup> removed the barriers posed by the so-called Douglas Amendment on interstate bank mergers.<sup>245</sup> Other barriers to interstate branching were dropped in 1997, allowing nationwide banking under a single charter.<sup>246</sup> This set off an interstate bank merger boom, which required CRA credits.

A 1992 study by the Federal Reserve Bank in Boston charged that there was strong statistical evidence of racial discrimination in mortgage lending.<sup>247</sup> Members of Congress, including Barney Frank of Massachusetts and Senator Christopher Dodd of Connecticut, used that study to push for more subprime lending.<sup>248</sup> The Clinton administration adopted that platform and took advantage of this new demand for bank mergers through its National Homeownership Strategy, which sought to increase home ownership by subprime borrowers through the lever of the CRA.<sup>249</sup> 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.”<sup>250</sup> The Clinton

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(codified at 12 U.S.C. §§ 2801-2811 (2006)).

242. Community Reinvestment Act of 1977, Pub. L. No. 95-128, 91 Stat. 1147 (codified at 12 U.S.C. §§ 2901 *et seq.* (2006)).

243. *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).

244. Pub. L. No. 103-328, 108 Stat. 2338 (1994).

245. 12 U.S.C. § 1842(d). *See* Ne. Bancorp, Inc. v. Bd. of Governors of the Fed. Reserve Sys., 472 U.S. 159 (1985) (describing the scope of the Douglas Amendment).

246. Riegle-Neal authorized interstate branching by merger or acquisition of a bank unless a state opted out of such branching. New branches were not authorized unless a state passed a law affirmatively allowing it. Congress gave the states until May 31, 1997 to determine whether they would opt out. 12 U.S.C. §36(g).

247. Alicia H. Munnell, Lynn E. Browne, James MoEneaney & Geoffrey M. B. Tootell, *Mortgage Lending in Boston: Interpreting HMDA Data* 43-44 (Fed. Reserve Bank of Boston, Working Paper No. 92-7, Oct. 1992).

248. CHARLES GASPARINO, *THE SELLOUT* 110-11 (2007).

249. *See* William J. Clinton, U.S. President, White House: Remarks on the National Homeownership Strategy, 1 PUB. PAPERS 805 (June 5, 1995) (noting that the homeownership strategy “help[s] moderate income families who pay high rents but haven’t been able to save enough for a downpayment . . . [and] lower income working families who are ready to assume the responsibilities of home ownership but [are] held back by mortgage costs that are just out of reach”).

250. *Modernizing America’s Financial Regulatory Structure: Hearing Before the Cong. Oversight Panel*, 111th Cong. 12 (Jan. 14, 2009) (testimony of Marc Sumerlin, Managing

administration's CRA efforts led to an eighty percent increase in the number of subprime mortgages.<sup>251</sup> "Subprime mortgage originations grew from \$35 billion in 1994 to \$140 billion in 2000, indicating an average annual growth rate of 26%."<sup>252</sup>

The Federal Reserve Board advised banks that CRA loans were to be made in a safe and sound manner.<sup>253</sup> That admonition begged the question: how do you make a safe and sound subprime loan when, as Federal Reserve Chairman Ben Bernanke has candidly admitted, those borrowers pose a "high credit risk?"<sup>254</sup> 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.<sup>255</sup> 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."<sup>256</sup> 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

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Director and Co-Founder, The Lindsey Group), *available at* <http://cop.senate.gov/documents/testimony-011409-sumerlin.pdf>.

251. Roberta Achtenberg, a HUD assistant secretary, established a nationwide CRA enforcement program that was designed to compel 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.

MCDONALD & ROBINSON, *supra* note 9, at 4.

252. Elizabeth Laderman, *Subprime Mortgage Lending and the Capital Markets*, FRBSF ECONOMIC LETTER (Fed. Reserve Bank of S.F., S.F., Cal.), Dec. 28, 2001, at 1, *available at* <http://www.frbsf.org/publications/economics/letter/2001/el2001-38.pdf>.

253. See Fed. Reserve Bd., *Community Reinvestment Act*, July 10, 2008, <http://www.federalreserve.gov/dcca/cra> ("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.")

254. Ben S. Bernanke, Chairman, Fed. Reserve, Speech at the Federal Reserve Bank of Chicago's 43rd Annual Conference on Bank Structure and Competition: The Subprime Mortgage Market (May 17, 2007), *available at* <http://www.federalreserve.gov/newsevents/speech/bernanke20070517a.htm>.

255. Russell Roberts, *How Government Stoked the Mania*, WALL ST. J., Oct. 3, 2008, at A21.

256. Cynthia Angell & Clare D. Rowley, *Breaking New Ground in U.S. Mortgage Lending*, FDIC OUTLOOK (Fed. Deposit Ins. Corp., Wash., D.C.), Summer 2006, at 21, 22.

1998 acquisition of HF Ahmanson & Co.<sup>257</sup> The merger of Citibank and the Travelers Group in 1999 resulted in a ten-year, \$115 billion CRA pledge.<sup>258</sup> Bank of America made a ten-year CRA subprime lending pledge of \$750 billion when it merged with FleetBoston Financial Corp. in 2003.<sup>259</sup> JPMorgan Chase made a larger \$800 billion CRA pledge when it merged with Bank One Corp. in 2004.<sup>260</sup> One website, which is highly critical of these pledges, claims that total CRA commitments by banks reached \$4.2 trillion by 2004.<sup>261</sup>

The Federal Reserve Board has contended that the CRA did not cause the subprime crisis because many subprime loans did not have CRA credit.<sup>262</sup> One author argues that the CRA was not responsible for the subprime crisis for three reasons: (1) few CRA loan applications were denied, a fact which the author seems to suggest demonstrates that 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, leading the author to believe that the CRA had little effect elsewhere, and therefore was not to blame.<sup>263</sup> These claims overlook the fact that the CRA required, and thereby legitimized, subprime lending by institutions that had previously shied away from such risky loans. As former Federal Reserve Chairman Alan Greenspan testified before Congress in October 2008: “It’s instructive to go back to the early stages of the subprime market, which has essentially emerged out of the CRA.”<sup>264</sup>

After being forced into the market by the federal government, banks found this business to their liking. Yet, this is another unfortunate legacy of the CRA. Former Senator Phil Gramm noted: “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

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257. Jaret Seiberg, *Minority Report*, THE DAILY DEAL, Nov. 3, 2003, available at <http://www.accessmylibrary.com/article-1G1-109542717/minority-report.html>.

258. BROOME & MARKHAM, *supra* note 84, at 405-06.

259. Craig Lender, *B of A Chief Raps CRA Overhaul*, AM. BANKER, Apr. 26, 2004, at 8.

260. BROOME & MARKHAM, *supra* note 84, at 405-06.

261. Steve Sailer, *The Minority Mortgage Meltdown (cont.): Charting the CRA Crackup*, VDARE.COM, Feb. 15, 2009, [http://www.vdare.com/sailer/090215\\_cra.htm](http://www.vdare.com/sailer/090215_cra.htm).

262. Randall S. Kroszner, Governor, Fed. Reserve, Speech at the Confronting Concentrated Poverty Policy Forum: The Community Reinvestment Act and the Recent Mortgage Crisis (Dec. 3, 2008), in REVISITING THE CRA: PERSPECTIVES ON THE FUTURE OF THE COMMUNITY REINVESTMENT ACT 8 (2009). Both the Clinton and George W. Bush administrations also pushed toward more subprime lending by two giant government-sponsored enterprises (“GSEs”), Fannie Mae and Freddie Mac. By 2000, about fifty percent of their portfolios were subprime products. *The Subprime Lending Bias*, INVESTOR’S BUSINESS DAILY, Dec. 22, 2008, at A14. That quota was increased to fifty-two percent in 2005. WILLIAM D. COHEN, HOUSE OF CARDS 297 (2009).

263. Charles E. Daye, *Stripping Off Market Accountability: Housing Policy Perspectives on the Crisis in the Financial System*, 13 N.C. BANKING INST. 105, 110-11 (2009).

264. Gramm, *supra* note 157, at A17 (citation omitted).

appearing to be a lucrative business in which risks could be managed through securitizations.<sup>265</sup> 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.<sup>266</sup>

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 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.”<sup>267</sup> 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.”<sup>268</sup> Senator Gramm inserted a provision in the Gramm-Leach-Bliley Act in 1999 that required reports to be filed disclosing any CRA extortion payments, hoping that disclosure would embarrass those groups and keep such demands to a minimum.<sup>269</sup>

### C. 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.<sup>270</sup> Even before the enactment of that exemption,

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265. *Id.*

266. BROOME & MARKHAM, *supra*, note 84, at 412.

267. Susan Sirota Gaetano, *An Overview of Financial Services Reform 1998*, 5 CONN. INS. L. J. 793, 807 n.129 (1999).

268. COHEN, *supra* note 262, at 297 (quoting Russell Roberts, professor of economics at George Mason University).

269. 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, 294 (1993) (finding that the CRA has done more harm than good).

270. Futures Trading Practices Act of 1992, Pub. L. No. 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 swap had grown to a notional amount of some \$4 trillion by the end of 1991.<sup>271</sup> 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 Bank of Switzerland.<sup>272</sup> 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.<sup>273</sup>

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."<sup>274</sup> 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.<sup>275</sup> The OCC bulletin opined that the 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 the CDS, including credit, liquidity, price, transaction and strategic risks.<sup>276</sup>

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*the Commodities Markets*, 39 BUS. LAW. 1719 (1984).

271. Jerry W. Markham, "Confederate Bonds," "General Custer," and the Regulation of Derivative Financial Instruments, 25 SETON HALL L. REV. 1, 3, n.8 (1994).

272. MARKHAM II, *supra* note 114 at 240.

273. *Id.*

274. O.C.C. Bulletin 96-43, to Chief Executive Officers of all National Banks, Department and Division Heads, and all Examining Personnel, at 1 (Aug. 12, 1996), available at <http://www.occ.treas.gov/ftp/bulletin/96-43.doc>.

275. 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.

276. *Id.*

The OCC was right to be concerned because ten years later those risks would eventually manifest themselves in the subprime crisis. 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.

## VI. WHAT CAUSED THE SUBPRIME CRISIS?

### A. *Excessive risk?*

The 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.<sup>277</sup> 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.<sup>278</sup> 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.<sup>279</sup> Merrill Lynch wrote down \$5.7 billion in 2008 due to its exposure to Super Senior CDOs.<sup>280</sup> 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 Star Funds for \$6.7 billion, which accounted for \$4.4 billion of the write-down.<sup>281</sup> The remainder of the write-down was a result of Merrill Lynch "terminat[ing] certain hedges with monoline financial guarantors related to U.S. super senior ABS CDOs."<sup>282</sup>

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277. See, e.g., Susanne Craig, Randall Smith, *Merrill Aims to Raise Billions More: Firm Dumps Mortgage Assets as Crisis Drags On; Another Big Write-Down*, WALL ST. J., July 29, 2008, at A1 (discussing Merrill Lynch's decision to sell "\$30 billion in toxic mortgage-related assets at a steep loss" in order to "purge" its balance sheet of perpetual problems).

278. GILLIAN TETT, *FOOL'S GOLD* 63-64 (Free Press 2009).

279. MERRILL LYNCH, 2008 ANNUAL REPORT 27 (2008).

280. *Id.* at 19-20.

281. *Id.* at 19, 28.

282. *Id.* at 19. 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

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.<sup>283</sup> "As of September 30, 2007, Citigroup's Securities and Banking (S&B) Business 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."<sup>284</sup> 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."<sup>285</sup> Citigroup also "recorded a pretax loss on CVA of \$5.736 billion on its exposure to monoline insurers," the majority of which related to hedges on Super Senior positions.<sup>286</sup> UBS AG was another bank that was hard hit by Super Senior

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thus experienced "[n]et losses due to credit valuation adjustments ("CVA") related to certain hedges with financial guarantors of \$10.4 billion." *Id.* at 18. 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. *Id.* 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." *Id.* In addition "[n]et losses of \$6.5 billion resulting primarily from write-downs and losses on asset sales across residential mortgage-related exposures and commercial real estate exposures." *Id.* Finally, "[n]et losses of \$2.1 billion due to write-downs on private equity investments." *Id.* There were other non-super senior ABS CDO related factors that drew down returns, including: additional dividends related to a 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.* at 18.

283. CITIGROUP, INC., 2008 ANNUAL REPORT 10 (2008).

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

285. CITIGROUP, INC., *supra* note 283, at 10.

286. *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, "[d]ue 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] record[ed] 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 \$18.3 billion in write-downs from lending and structuring exposures in the subprime markets. *Id.* at 10. Citigroup also posted \$3.3 billion in losses related to structured investment vehicle (SIV) trading through November 18, 2008, as well as \$2.6

write-offs. Of its \$18.7 billion in losses from U.S. subprime exposures, fifty percent were due to Super Seniors.<sup>287</sup>

AIG had no idea that it was incurring excessive risk in its Super Senior CDS. AIG assured investors in August 2007 that “[i]t 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.”<sup>288</sup> AIG was weakened after it wrote off \$11.12 billion on Super Senior CDS in the fourth quarter of 2007 and another \$9.11 billion in the first quarter of 2008.<sup>289</sup> 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.<sup>290</sup> AIG’s CEO, Martin Sullivan also blamed mark-to-market accounting requirements for the losses sustained by AIGFP.<sup>291</sup> Sullivan complained that AIG was required to markdown its inventories even if it had no intention of selling them.<sup>292</sup> He may have had a point, as this was a common complaint in the industry.<sup>293</sup> Indeed, at the

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billion worth of pre-tax losses, net of hedges, on commercial real estate exposure. *Id.* at 11. Finally, an auction rate securities settlement added \$926 million to Citigroup’s 2008 losses. *Id.* at 13.

287. UBS AG, *supra* note 152, § 4.2.3, at 14.

288. Robert O’Harrow, Jr. & Brady Dennis, *Downgrades And Downfall: How could a single unit of AIG cause the giant company’s near-ruin and become a fulcrum of the global financial crisis? By straying from its own rules for managing risk and then failing to anticipate the consequences*, WASH. POST, Dec. 31 2008, at A01.

289. *AIG Reports First Quarter Results*, AIG NEWS (Am. Int’l Group, Inc., New York, N.Y.), May 8, 2008, available at [http://media.corporate-ir.net/media\\_files/irol/76/76115/releases/1Q08\\_release.pdf](http://media.corporate-ir.net/media_files/irol/76/76115/releases/1Q08_release.pdf).

290. *AIG Issues Statement on Super Senior CDS Loss Risk*, BUSINESS WIRE, Feb. 12, 2008, available at <http://www.reuters.com/article/idUS151781+12-Feb-2008+BW20080212>.

291. 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. 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/ai-aig1>.

292. 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.

293. 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. SERVICES OUTLOOK (Am. Enterprise Inst. for Pub. Pol’y, Washington D.C.), July 2008, at 2. That concept was further

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.<sup>294</sup>

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.<sup>295</sup> "As of the end of August 2008, AIG had posted approximately \$19.7 billion of collateral under its super senior credit default swap portfolio."<sup>296</sup> 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.<sup>297</sup>

Fair value pricing resulted in a pro-cyclical progression of write-downs that bore no relation to actual value.<sup>298</sup> "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.<sup>299</sup> Critics of fair value accounting charged that, because liquidity in subprime investments had dried up as the subprime

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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.* at 3.

294. Am. Int'l Group, Inc., 2009 Quarterly Report (Form 10-Q), at 5 (Aug. 7, 2009).

295. Am. Int'l Group, Inc., 2008 Annual Report (Form 10-K), at 3 (Mar. 2, 2009). Collateral calls by some large institutions totaling \$27.1 billion were paid in full when the government stepped into bailout AIG. Tom Braithwaite, *Geithner Faces Fresh Fire Over AIG Deal*, FIN. TIMES (London), Jan. 28, 2010, at 1. Treasury Secretary Tim Geithner was criticized harshly in Congress for paying those calls in full while head of the New York Federal Reserve Bank. *Id.* It was claimed that he was protecting Goldman Sachs and others making these collateral calls from losses and that he could have negotiated down the amounts of those payments. *Id.*

296. Am. Int'l Group, Inc., *supra* note 295, at 40. 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. Am. Int'l Group, Inc., *supra* note 294, at 67. These losses appear largely to be related to fair value accounting. *Id.* at 61, 67.

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

298. *Id.*

299. WESSEL, *supra* note 6, at 128.

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, “[m]ay the souls of those who developed FASB 157 burn in the seventh circle of Dante’s Hell.”<sup>300</sup> Warren Buffett likened mark-to-market requirements for measuring bank regulatory capital to throwing “gasoline on the fire in terms of financial institutions.”<sup>301</sup>

### B. 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 twice during that bull market, reaching a height of 11722 on January 14, 2000.<sup>302</sup> 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.<sup>303</sup> It was also attributed to low interest rates encouraged by the Fed.<sup>304</sup> Greenspan single-handedly broke the

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300. *Accounting Principles*, 40 SEC. REG. & L. REP. (BNA) 1767 (Oct. 27, 2008).

301. Holman W. Jenkins, Jr., *Buffett’s Unmentionable Bank Solution*, WALL ST. J., Mar. 11, 2009, at A13; *see also* American Int’l Group, Inc., 2009 Quarterly Report for the Period Ending 30 June, 2009 (Form 10-Q), at 61, 67 (Aug. 7, 2009) (disclosing ongoing investigations by the SEC and DOJ of its valuation of its super senior credit default swap portfolio under fair value accounting rules). 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*, 173 AM. BANKER 1 (Mar. 24, 2008).

302. 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.

303. E.S. Browning, *Dow Leaps in Skeptics’ Rally: Cheap Money Sends Shares to 2009 High, Gold Over \$1,100; Dollar’s Dive Continues*, WALL ST. J., Nov. 10, 2009, at A1.

304. 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.

dot.com bubble through a series of punitive interest rate increases.<sup>305</sup> Trillions of dollars in stock values evaporated in the ensuing downturn.<sup>306</sup> 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.<sup>307</sup>

The fed funds rate was 6.51 percent in November 2000.<sup>308</sup> It dropped to nearly one percent in July 2003.<sup>309</sup> 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.<sup>310</sup> 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 more interest rate increases.<sup>311</sup> 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.<sup>312</sup>

Undeterred by that rather ominous news, Bernanke imposed another rate increase on March 28, 2006.<sup>313</sup> 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.<sup>314</sup> The seventeenth consecutive increase came on June 29, 2006, increasing short-term rates to 5.25 percent.<sup>315</sup> The effect of this onslaught on the real estate

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305. JERRY W. MARKHAM, *A FINANCIAL HISTORY OF MODERN CORPORATE SCANDALS: FROM ENRON TO REFORM*, ch. 2 (2005).

306. David Wessel, *Capital: Great Expectations And Greenspan*, WALL ST. J., Mar. 22, 2001, at A1.

307. 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., Mar. 21, 2001, at A1.

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

309. 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.

310. The Associated Press, *Shares Close Mixed as Earnings Reports Fail to Inspire*, N.Y. TIMES, Jan. 20, 2007, at C1.

311. ETHAN S. HARRIS, *BEN BERNANKE'S FED* 32 (2008).

312. Paul Krugman, *Coming Down To Earth*, N.Y. TIMES, May 19, 2006, at A25.

313. 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., Mar. 29, 2006.

314. HARRIS, *supra* note 311 at 176.

315. The Associated Press, *supra* note 310.

market culminated in a financial crisis in 2007. Home sales and new residential construction slowed dramatically, and the market became glutted with unsold homes.<sup>316</sup>

The Fed then began slashing rates once again, pushing short-term rates to near zero.<sup>317</sup> This raises the question of whether another bubble is being formed in one asset class or another that will eventually break 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.<sup>318</sup> Those debates and policies dominate Fed thinking until there is an economic crisis that causes concerns over inflation to be abandoned, but not until a significant amount of damage has been done to the economy. This approach is wrong-headed, and should be corrected by adding more certainty to the process in order to allow better business and economic 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 leaves 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 interest rates 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.”<sup>319</sup>

Any interest rate changes should be measured and slow. The effects of interest rate changes are not visible for some months, a fact that 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 was 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 the Fed has given only the vaguest of suggestions concerning its

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316. Jack Healy, *October Report Shows Home Prices Down 18% From Last Year*, N.Y. TIMES, Dec. 31, 2008, at B3.

317. Edmund L. Andrews, *Fed’s Minutes Reveal Shock at Downturn*, N.Y. TIMES, Jan. 7, 2009, at B1.

318. Bob Davis, *World News: IMF Tells Bankers to Rethink Inflation*, WALL ST. J., Feb. 12, 2010, at A10.

319. WESSEL, *supra* note 6, at 122.

future rate policy. The only guidance the Fed has provided was that rates would stay low for an “extended period,” which means at least six months.<sup>320</sup> 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, indicating that the Fed has learned nothing from observing the effects of its roller coaster rate changes.<sup>321</sup>

### C. *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 the GLBA. The “no-doc,” “low-doc,” stated income (“liar loans”) and “Ninja” (no income, no job, no assets) and “teaser” rate loans were sometimes irresponsibly underwritten on the belief that an ever-rising housing market would allow refinancings and avoid foreclosure.<sup>322</sup> 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.<sup>323</sup> 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,<sup>324</sup> but they were

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320. 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.

321. Jon Hilsenrath, *Fed Official Sees Faster Rate Increases in Future*, WALL ST. J., Sept. 26-27, 2009, at A2. The Fed was under attack by Congressman Ron Paul who was able to gain enough support to insert a provision in the regulatory reform legislation pending in the House Financial Services Committee that would require GAO audits of Fed monetary policy. *Audit the Fed Amendment Passes 43-26!*, RONPAUL.COM, Nov. 19, 2009, <http://www.ronpaul.com/2009-11-19/audit-the-fed-amendment-passes-43-26/>. Paul also advocated abolishing the Fed. RON PAUL, END THE FED (2009).

322. See MUOLO & PADILLA, *supra* note 111 (describing these abuses).

323. TETT, *supra* note 278, at 101-02.

324. 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 BROOK. J. INT'L L. 221 (2000) (discussing the role of VaR).

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 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.<sup>325</sup>

Critics of GLBA have asserted that the commercial banks greatly leveraged their balance sheets following the repeal of Glass-Steagall by increasing their ratio of debt to equity.<sup>326</sup> However, banks have always been highly leveraged institutions that were dependent on deposit liabilities to fund much of their operations. Increased leverage was also a function of changes in regulatory capital requirements that sought to limit bank leverage. That process began in 1988 with the “Basel Accord,” formulated by the Basel Committee at the Bank for International Settlements. That committee was composed of a group of central bankers and regulators, including those in the United States. The capital formula in that Accord proved to be too inflexible, and a risk-based approach was adopted in Basel II instead. That process began in 1999, coinciding with the passage of GLBA, but does not appear to be related to its passage. It was also mistakenly thought that Basel II would increase capital cushions and decrease leverage.<sup>327</sup> That flaw was due to the assumption that the triple-A rated Super Senior tranches of the CDOs were safe and did not require a large capital cushion.

## 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.

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325. For a lively discussion of those flaws, see NASSIM NICHOLAS TALEB, *THE BLACK SWAN* (2007).

326. CHARLES GASPARINO, *THE SELLOUT* 154 (2007).

327. For a discussion of the development of Basel II, see BROOME & MARKHAM, *supra* note 84, at 519-25.