Debunking "The Big Lie": Blame Wall Street Not Housing Policy

Melvin W. LaPrade
laprade@nurg.org

National Urban Research Group

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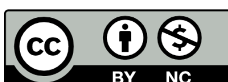
Abstract

Five years after the *Great Recession of 2008*, described as the first crisis of globalization by former British Prime Minister and Chancellor of the Exchequer Gordon Brown, the economic financial crisis continues to set off a protracted ideological struggle of competitive narratives. There is a singular point of agreement. That is, the financial crisis, originating in the United States subprime mortgage sector, threatened the complete collapse of the entire global economy system. Opinions diverge, however, on how dealings in a relatively obscure sector of the financial system cascaded into an economic global contagion. A widely accepted perception purports that misguided affordable homeownership mandates and government subsidization of mortgage risk is a root cause. Sustained attention on government intervention as a primary cause of the financial crisis reflects a powerful consensus among conservative and libertarian public policy think tanks, university scholars, and policymakers. Cynically known as "The Big Lie narrative", this vigorous movement to rewrite history is an attempt to shape the financial reform agenda by devising and promoting the notion that government intervention in housing is not required and even counterproductive.

Contrary to the "Big Lie" narrative, in reality, much of the impetus behind the collapsing architecture of the financial sector, including those affecting housing, does not represent a failure in government intervention, but rather a Wall Street induced macroeconomic financial shock spawned by a failure of federal regulatory oversight over systemically important financial institutions. Therefore, we find the "Big Lie" thesis both unpersuasive and a distraction. The "Big Lie" narrative is unpersuasive because it exaggerates the role of government intervention in housing as the central cause for a global economic crisis while discounting the role of financial deregulation. This narrative is also a distraction in its shrewdness. It diverts attention away from the need for financial sector regulatory oversight and Wall Street reforms, while placing far too heavy a burden on the homeownership aspirations and mortgage credit needs of traditionally underserved communities as a principal source for a multi-trillion dollar global economy crisis.



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Introduction

In the extraordinarily wake of the global economic meltdown, the Bush Administration, with bipartisan support, enacted the Emergency Economic Stabilization Act (EESA). EESA, created the 700 billion dollar Troubled Asset Relief Program (TARP) "to enable the Department of the Treasury to promote stability in financial markets through the purchase and guarantee of 'troubled assets.'" [1] The origination purpose of TARP was the purchasing of "toxic" asset-based securities for major financial firms, however, TARP funds were in the end used as direct taxpayer funded equity investments under the Treasury Department's Capital Repurchase Program. According to a Congressional Budget Office (CBO) "on transactions completed, outstanding, and anticipated under TARP as of March 3, 2011," the Treasury purchased preferred stock from 707 economic distress financial institutions totaling $205 billion through the Capital Purchase Program (CPP). [2] Financial institutions in receipt of the largest TARP funds included AIG, Bank of America, Citigroup, Goldman Sachs, JPMorgan Chase, Morgan Stanley, PNC Financial Services, U.S. Bancorp, and Wells Fargo.[3] A Treasury report noted, TARP has "continued to strengthen the financial system as more banks have repaid the government's investments, replacing public support with private capital."[4] As of June 30, 2011, "total repayment and income on TARP investments were approximately $308

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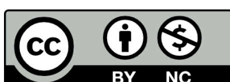
[1]The EESA was enacted as Division A of Public Law 110-342 The legislation passed by a margin of 74 to 25 in the Senate and a vote of 263 to 171 in the House.

[2] CBO *Report on the Trouble Asset Relief Program* available at, http://www.cbo.gov/ftpdocs/121xx/doc12118/03-29-TARP.pdf

[3] Matthew Ericson, Elaine He and Amy Schoenfeld, *Tracking the $700 Billion Bailout*, N.Y. TIMES available at, http://www.nytimes.com/packages/html/national/200904_CREDITCRISIS/recipients.html

[4] The Department of the Treasury, Office of Financial Stability—*Troubled Assets Relief Program. Citizen's Report, Fiscal Year 2011*, available at, http://www.treasury.gov/initiatives/financial-stability/briefing-room/reports/other/DocumentsOther/FY%202011%20TARP%20Citizens%20Guide%20%202%2015%2012.pdf



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billion, which is 75 percent of the $412 billion in total disbursements to date."[5]

Alongside TAPR, the U.S. Treasury Department and Federal Reserve introduced several corresponding emergency recovery efforts to stabilize the financial system. Equivalent economic recovery efforts include the Federal Reserve Term Securities Lending Facility (TSLF) and Primary Dealer Credit Facility (PDCF) programs peaking at $483 billion and $156 billion, respectively. The Federal Reserve money market funding peaked at $350 billion in January 2009, and the Fed's Commercial Paper Funding Facility peaked at $365 billion. The Fed's largest program, Regulatory Reform: Agency Mortgage-backed Securities (MBS) Purchase Program, procured $1.25 trillion in Wall Street subprime mortgage-backed securities. Finally, the Federal Deposit Insurance Corporation (FDIC) pledged to backstop as much as $939 billion in bank debt to guarantee senior debt for all FDIC-insured institutions. [6] Bloomberg News, based on information obtained under the Freedom of Information Act, estimated that as of March 2010, "add up guarantees and lending limits, and the Fed committed $7.77 trillion to rescuing the financial system, more than half the value of everything produced in the U.S. that year." [7]

Policymaking shifted from economic containment to addressing the underlining causes of the financial crisis. On January 27, 2011, the Financial Crisis Inquiry Commission (FCIC) released their *Final Report on the Causes of the Financial Crisis* (FCIC Final Report). The Final Report, according to the FCIC Chairman, is "an attempt

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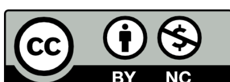
[5] Memorandum for the President, From OMB Director Jacob J. Lew, Transmittal of the Office of Management and Budget, Required Report per the Emergency Economic Stabilization Act of 2008, available at, http://www.whitehouse.gov/sites/default/files/omb/reports/emergency-economic-stabilization-act-of-2008.pdfency.

[6] For reviews of these programs see, Financial Crisis Inquiry Final Report (Chapter 20), pp. 375-376, also see footnote 6, p. 531. available at www.fcic.gov

[7] Bob Ivry, Bradley Keoun and Phil Kuntz, *Secret Fed Loans Gave Banks $13 Billion Undisclosed to Congress*," Bloomberg Market Magazine, November 27, 2011, available at, http://www.bloomberg.com/news/2011-11-28/secret-fed-loans-undisclosed-to-congress-gave-banks-13-billion-in-income.html



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to recode history, not to rewrite it, nor allow it to be rewritten." [8] The *Final Report* blamed "reckless" Wall Street firms and "weak" federal regulators as primary contributors to the economic collapse. [9] In a strongly worded dissenting view, FCIC Commissioner Peter Wallison blamed affordable housing policies during the administrations of Presidents Bill Clinton and George W. Bush, not "deregulation, lack of regulation, predatory lending or other factors." He wrote,

'There are always many factors that could have caused an historical event; the difficult task is to discern which, among a welter of possible causes, were the significant ones—the ones without which history would have been different. Using this standard, I believe that the *sine qua non* of the financial crisis was U.S. government housing policy, which led to the creation of 27 million subprime and other risky loans—half of all mortgages in the United States—which were ready for default as soon as the massive 1997-2007 housing bubble began to deflate. If the U.S. government had not chosen this policy path—fostering the growth of a bubble of unprecedented size and an equally unprecedented number of weak and high risk residential mortgages—the great financial crisis of 2008 would never have occurred… The appropriate policy choice was to reduce or eliminate the government's involvement in residential mortgage markets, not to impose significant new regulation on the financial system." [10]

Answering the question of causality is an essential component of the still developing shape of financial regulatory reforms in a post-crisis world. Financial sector reorganization similar to any policy reform reflects the powers of ideals. The policy agenda will be a function of how narratives on its causes influence and inform regulatory restructuring. Conservative policymakers incessant mimicking of the notion that

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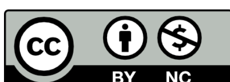
[8] Congress established the Financial Crisis Inquiry Commission (FCIC) to "determine what happened and how it happened so that we could understand why it happened." The FCIC "statutory instruction set out 22 specific topics for inquiry and called for the examination of the collapse of major financial institutions that failed or would have failed if not for exceptional assistance from the government." The Commission also examined the roles of policy makers and regulators. In the course of the FCIC investigation, over 700 witnesses were interviewed and 19 days of hearings in communities across the country hard hit by the crisis were held, see *Financial Crisis Inquiry Commission Release Report on the Causes of the Financial Crisis*, Media Advisory, January 27, 2011, available at www.fcic.gov

[9] *Conclusion of the Financial Crisis Inquiry Commission*, available at http://c0182732.cdn1.cloudfiles.rackspacecloud.com/fcic_final_report_conclusions.pdf

[10] *Financial Crisis Inquiry Commission Dissenting Statement of Peter J. Wallison*, available at http://c0182732.cdn1.cloudfiles.rackspacecloud.com/fcic_final_report_wallison_dissent.pdf



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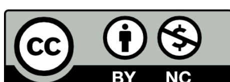
government intervention in housing created the financial crisis is an ideology driven movement. Within this framework, markets are adequately rational as to justify a strong presumption in favor of market deregulation. As described by Barry Ritholz, the goal is to substitute one false narrative, “the discredited belief that free markets require no adult supervision”, for the “Big Lie narrative” that “the entire boom and bust was caused by misguided government policies.”[11] This essay contributes to current debates in two important ways. First, I show how the “Big Lie” narrative achieved footing at the center of the policy agenda and linger stubbornly in place. Next, I depart from the “Big Lie” narrative by examining the broader perspective of financial deregulation, rather than government intervention in housing alone, as a primary cause of the global financial crisis.

The Big-Lie Narrative

Joe Nocera, business columnist for the New York Times, illustrates how the promotion of the “Big Lie” narrative is an attempt to shape public policy by devising and promoting the concept that government intervention in housing is not required and even counterproductive. Nocera outlined the “Big Lie” process steps:

> So this is how the Big Lie works.
> You begin with a hypothesis that has certain surface plausibility. You find an ally whose background suggests that he’s an “expert”; out of thin air, he devises “data.” You write articles in sympathetic publications, repeating the data endlessly; in time, some of these publications make your cause their own. Like-minded congressmen pick up your mantra and invites you to testify at hearings.
>
> You’re chosen for an investigative panel related to your topic. When other panel members, after inspecting your evidence, reject your thesis, you claim that they did so for ideological reasons. This too, is repeated by you’re allies. Soon, the echo chamber you created drowns out dissenting view; even presidential

[11] Barry Ritholz, What caused the financial crisis? The Big Lie goes Viral, Washington Post, November 5, 2011, http://www.ritholtz.com/blog/2011/11/what-caused-the-financial-crisis-the-big-lie-goes-viral/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candidates begin repeating the Big Lie."[12]

In his book *The Housing Boom and Bust*, economist Thomas Sowell, a scholar in residence at the conservative Hoover Institution at Stanford University, provides a seminal "Big Lie" hypothesis. Sowell enumerates the elements that, in his view, were responsible for the housing boom and bust. He argues that "there were many who shared the responsibility - or, in this case, the irresponsibility—for the housing boom that was fueled by easier credit, lower mortgage approval standards and "creative" financing."[13] Under intense lobbying pressure, he writes, members of Congress from both political parties urged extreme risk-taking and regulatory forbearance on banks and secondary mortgage actors, requiring them to lower mortgage loan requirements. Both Presidents Clinton and Bush, in different ways, contributed to the inflation and collapse of the housing bubble by pursuing ambitious agendas of encouraging home ownership for borrower with higher mortgage lending risks.[14] Sowell is widely read, and Congressional members on the political right often use Sowell's and other Hoover Institute's position paper when advancing the "Big Lie" government intervention narrative.

A 2009 United States Congress Republican House Minority Staff Report advanced the "Big Lie" thesis. According to the report, federal government intervention in the U.S. housing market created a "mortgage tsunami" of "dangerous lending policies which encouraged lower down payments, looser underwriting standards and higher leverage."[15] A *Harvard Journal of Law & Public Policy* essay written by Republican

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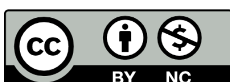
[12] Joe Nocera, *The Big Lie*, N.Y. TIMES, The Opinion Pages, December 23, 2011,available at, http://www.nytimes.com/2011/12/24/opinion/nocera-the-big-lie.html?_r=1

[13] Sowell (2009), Chapter 2.

[14] *Ibid.*

[15] The Role of Government Affordable Housing Policy in Creating the Global Financial Crisis of 2008, Staff Report, U.S. House of Representatives 111th Congress, Committee on Oversight and Government Reform, July 7, 2009, available at http://www.hsgac.senate.gov//imo/media/doc/Financial_Crisis/FinancialCrisisReport.pdf?attempt=2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Congressman Darrell Issa reiterates the “Big Lie” storyline that the financial crisis was “directly tied to an over-inflated housing bubble wherein mortgage lenders made reckless, high-risk loans.” [16] According to Issa, the Minority Ranking Member of Committee on Oversight and Government Reform, mortgages were “given in record numbers to over-extended, under-qualified borrowers to satisfy an increasingly aggressive government drive for home ownership.” The “echo chamber” recitation of the “Big Lie” reached a zenith when Republican Presidential candidate Mitt Romney repeated it during a GOP Debate, in response to a question by CNBC’s Steve Liesman regarding the housing crisis, Romney said,

> “…markets work. When you have government play it’s heavy hand, markets blow up and the people get hurt…the reason we have the housing crises we have is the federal government played too heavy role…they played a role in Fannie and Freddie. [Congressman Barney Franks] told banks they had to give loans to people…our friends in Washington today…they say oh. If we got a housing problem let’s let government play bigger role. That’s the wrong way to go. Let market work…”[17]

Conservative political interest groups, pundits, think tanks, and academic journal articles continually press forward rationalization for the unrelenting “Big Lie” government intervention theory in an attempt to absolved Wall Street from its primary role in causing the financial crisis. This vigorous movement to rewrite history is also an attempt to shape the policy agenda by devising and promoting the notion that government intervention in the financial sector is not required and even counterproductive. It is a fundamentally misunderstanding of empirical evidence and historical reality to conclude that the crisis resulted principally from government subsidization of mortgage risk. The history of financial deregulatory is a far more instructive place to begin when reviewing events leading to what former British Prime Minister and Chancellor of the Exchequer Gordon Brown called the first crisis of globalization.

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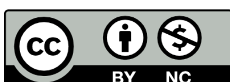
[16] Darrell Issa, Unaffordable Housing and Political Kickbacks Rocked the American Economy, *Harvard Journal of Law & Public Policy*, available at, http://www.harvard-jlpp-com/33-2/407.pdf

[17] Candidates: U.S. Can Thrived with less government , available at, http://www.cnbc.com/id/44932660/



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Elimination of Regulation Q

Policy reforms are often associated with crisis. During the Great Depression, the United States responded to the banking and economic collapse by passing a sequence of financial reforms. The Federal Home Loan Bank Act of 1932 created the modern Savings and Loan institution with a narrow focal point on the financing of residential mortgages while the Glass-Steagall Act of 1933 imposed restrictions on the range of activities allowable for commercial banks.[18] Congress also imposed mortgage interest rate ceilings under the Bank Act of 1933, Regulation Q of the Federal Reserve Act (Reg. Q). Scholars often described the financial sector as operating under the "3-6-3" rule. Thrifts provided 3 percent interest on demand deposits, provided mortgage at an interest rate of 6 percent, allowing bankers to be on the golf course by 3 o'clock, so-called "bankers' hours."

Reg. Q worked reasonably well as short-term interest rates remained below regulatory mandates. Beginning with the "Credit Crunch of 1966", however, binding Reg. Q regulatory ceilings caused slower or negative inflows because the ceilings prevented the payment of higher interest rates offered on alternative market instruments, often described as "regulation-induced disintermediation." On June 16, 1970, the call for deregulatory reforms of the financial system gained traction in the political discourse when President Richard Nixon commissioned a presidential task force, the Hunt Commission, to "review and study the structure, operation, and regulation of the private financial institutions." [19] Most of the Hunt Commission recommendations received scanty notice and would become mere footnotes in the history of financial deregulatory reform. However, one proposal, the gradual elimination of Reg. Q mandated interest rate ceilings,

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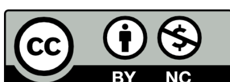
[18] Glass-Steagall **Section 16** restrictions included provisions prohibited depository bank from investing in Wall Street stock or dealing in securities. **Section 20** provided language making it illegal for securities firms to engage in depository transactions, and said bank members of the Federal Reserve affiliated with firms primarily engaged in the field of securities brokerage. **Section 21** forbade securities from accepting deposits. **Section 32** prohibited Federal Reserve member banks' board of directors, officers, or employees from membership in any organization that was "primarily engaged" in underwriting or dealing in securities.

[19] U.S. House Committee on Banking, Currency and Housing, Subcommittee on Financial Institution Supervision, Regulation and Insurance, Financial Institutions in the Nation's Economy (FINE), "Discussion Principles": Hearings, 94th Cong. 1st sess., 1975.



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received considerable attention and would become the blueprint for financial deregulation, endorsing an agenda of increased flexibility identified as "free competition" and taking away "government-involvement in the allocation of credit."[20]

Depository Institution Deregulation and Monetary Control Act of 1980

The early 1980s was the worst period for the banking sector since the Great Depression. The U.S. economy was still recovering from a period of economic stagflation -- unprecedented higher than historical standards of both inflation and unemployment rates.[21] Sharply rising interest rates combined with attractive alternative debt instruments resulted in a credit shortfall in the thrift industry. Congress phased out Req. Q interest ceilings with the enactment of H.R. 4986, the Depository Institution Deregulation and Monetary Control Act of 1980 (Monetary Control Act). President Carter, when signing the legislation, said, our banks and saving institutions are hampered by a wide range of outdated, unfair, and unworkable regulations." The Statement of findings and purpose of Title II of Monetary Control Act reads as follows:

> "The Congress hereby finds that limitations on the interest rates which are payable on deposits and accounts discourage persons from saving money, create inequities for depositors, impede the ability of depository institutions to compete for funds, and have not achieved their purpose of providing an even flow of funds for home mortgage lending."[22]

The legislation phased-out all Reg. Q ceilings including the elimination of "state mortgage usury ceilings and restriction on discount points, finance charges and other charges with respect to resident mortgage loans on real estate property."[23] Most important

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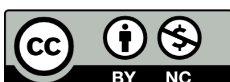
[20] Hunt Commission: Report to the President's Commission on Financial Structure and Regulation, U.S. Government Printing Office: Washington, D.C. (1971), pp. 23-112.

[21] Thomas F. Dernberg, "Stagflation: A Retrospective" available at www.mtsu.edu/~berc/tnbiz/economy/dernburg.html

[22] Depository Institutions Deregulation and Monetary Control Act of 1980, Title II, Section 202 (a).

[23] Ibid



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to the emergence of the subprime mortgage sector, the Monetary Control Act allowed financial institutions to introduce new mortgage products with terms including higher interest rates and other features previously prohibited by individual state laws.

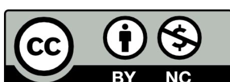
Garn - St. Germain Act of 1982

Ronald Reagan's presidency marked a discernible shift in U.S. housing policy pressing forward the *de facto* disintegration of Depression-era financial reforms. President Reagan famously declared that "government is not the solution to our problems; government is the problem." The "Regan Revolution" domestic agenda called for "free and deregulated" markets. Under President Reagan's direction, his administration advanced a free market economic philosophy guided by decreased government regulatory oversight. An emerging consensus suggested that the regulatory oversight measures of the financial sector were outdated and harmed the American banking system. In what President Reagan praised as "historic reform" and "the most important legislation for financial institutions in the last 50 years," Congress passed the Garn - St. Germain Act of 1982. [24]

Title VIII of the Act, known as the Alternative Mortgage Transaction Parity Act (Parity Act), eradicated "regulatory disparities" between state and federally chartered mortgage banks by authorizing non-federally chartered housing creditors to offer "alternative mortgage transactions."[25] The Parity Act preempted existing state lending mortgage usury laws by removing any provision of the "constitution or the law of any state expressly limiting the rate or amount of interest, discount points, finance charges" on any mortgage loans, provided the transactions were made in conformity with

[24] Garn-St. Germain Depository Institutions Act of 1982, Pub. L. 97-320, Section 403, 96 Stat. 1469, 1505-11.

[25] Alternative Mortgage Transaction Parity Act of 1982 ("AMTPA"), Garn-St Germain Depository Institution Act of 1982, Pub. L. No. 97-320, 96 Stat. 1469



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regulations issued by federal regulatory agencies.[26] These provisions opened the door for subprime mortgage products with terms including higher interest rates and other features previously prohibited by individual state laws.

History of Repeal of Glass-Steagall

Federal Reserve Chairman Paul Volcker firmly opposed the elimination of barriers that separated activities of investment banking from commercial banking. Chairman Volcker, and other opponents of deregulation, urged that the removal of legal and regulatory barriers would increase the systemic risk that the failure of a major financial institution could severely disrupt the financial system and have adverse spillover effects on the general economy. In 1986, despite Volcker's opposition, the Federal Reserve voted 3 to 2, overriding Volcker's resistance, to empower banking holding companies "on a case-by-case basis" to pursue an assortment of securities activities previously denied. [27] In 1989 the Federal Reserve increased the allowable gross revenue stream for Section 20 subsidiaries to 10 percent and then to 25 percent in 1996. When Volcker's term expired, President Reagan replaced him with Alan Greenspan, who advocated a "free market" approach toward financial markets. [28]

Chairman Greenspan felt federal regulatory oversight for housing finance was

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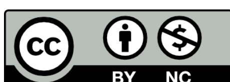
[26] The Parity Act defined "alternative mortgage transaction" as "a loan or credit sale secured by an interest in residential real property in which the interest rate or finance charge may be adjusted or renegotiated." Department of the Treasure Office of Thrift Supervision, 12 CFR Part 560, 590, and 591, no. 2002-43 RIN 1550-AB51, Alternative Mortgage Transaction Parity Act Preemption, p.3

[27] Known as "Section 20 subsidiaries", allowable underwriting activities included corporate debt and equity, asset-backed securities, and mortgage-backed securities. Bank holding companies could derive only 5 percent of their gross revenues from underwriting corporate debt and equity securities from Section 20 subsidiaries. For review of Federal Reserve actions, see Preliminary Staff Report, "The Role of the Federal Reserve in Banking Supervision and Regulation," Financial Crisis Inquiry Commission (April 7, 2010), available at, http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/2010-0407-Preliminary_Staff_Report_-_Role_of_Federal_Reserve_in_Bank_Supervision_and_Regulation.pdf

[28] According to press reports, White House officials were against Volcker's reappointment because he had become "too independent" and "too powerful" in his stance against major financial deregulation and reforms. See, Louis Uchitelle, "Alan Greenspan; Caution at the Fed." *New York Time Magazine*, January 15, 1989.



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defective and unsustainable and financial deregulation was essential in order to make the system more efficient. In one of his first statements before Congress, Chairman Greenspan declared that other countries have "usurp the United States" financial services sector's dominant role as international financial intermediaries. The loss of competitive edge, he adds, was a result of a "too rigid" regulatory structure and that financial services, "victimized by new technology and 'frozen' in a regulatory structure developed more than 50 years ago, were losing their competitive battle with other financial institutions and needed to obtain new powers to restore balance."[29] Reflecting this deregulatory philosophy, a 1998 Federal Reserve Board policy statement prohibited bank examiners from conducting routine consumer compliance examinations of nonbank subsidiaries and from investigating consumer complains related to these subsidiaries.[30]

The Clinton administration shared Greenspan's deregulatory philosophy towards the financial sector. President Clinton appointed Robert Rubin, the cochairman of Goldman Sachs, to run the White House council on economic policy. Espousing the economics of "Rubinomics", President Clinton economic framework presumed a need for balance budgets, free trade, and the globalization of deregulated financial markets. This free-market perspective represented the doctrine of the economic centrist "Blue Dog" wing of the Democratic Party. Specific policy objectives called for limited financial sector oversight and the abdication of regulatory oversight of financial mortgage products and derivatives.

Passage of Gramm-Leach-Bliley Act of 1999 (GLBA)

On April 6, 1998, Citicorp, the second largest commercial bank in the United States, announced a proposed merger with Travelers Group, who owned Salomon Smith Barney, one of the country's largest securities companies, and was the biggest property-casualty and life insurance company. The anticipated merger was noteworthy because it

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[29] *The New York Times*, "Greenspan Back New Bank Rules." September 24, 2009, p. D 1.

[30] Board of Governors of the Federal Reserve System, Division of Consumer and Community Affairs, Letter CA 98-1, dated January 29, 1998.

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was in direct violation of existing law. [31] The Federal Reserve, based on an obscure statutory allowance, announced its "conditional approval" of the merger. [32] On November 12, 1999, the deregulatory movement would reach a pinnacle with a multi-million dollar financial services industry subsidized lobbying effort, referred to on Capital Hill as the "Citi-Travelers Act", marking the demise of Glass-Steagall. President Clinton signed the Financial Services Modernization Act, universally known by the surnames of the key sponsors as the Gramm, Leach, and Bliley Act (GLBA). GLBA defined "financial services" broadly to include not only banking, insurance, and securities, but also activities that the Federal Reserve Board and Department of Treasury determined to be "financial in nature" or "complementary to a financial activity." [33]

Kenneth Guenther, President and CEO of Independent Community Bankers of America, in a PBS Frontline broadcast "The Wall Street Fix", offered his summary of events:

"I mean this is hubris in the worst sense of the word. Who do they think they are? Other people, firms, cannot act like this…Citicorp and Travelers were so big that they were able to pull this off. They were able to pull off the largest financial conglomeration —the largest financial coming together of banking, insurance and securities—when legislation was still on the books saying this was illegal, and they pulled this off with the blessing of the President of the United States, President Clinton; the Chairman of the Federal Reserve System, Alan Greenspan; and the Secretary of the Treasury, Robert Rubin…and when it's all over, what happens? The Secretary of the Treasury becomes the

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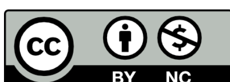
[31] Consumer Union, *Re: Application of Travelers Group Inc. Seeking Approval of Merger with Citigroup*, June 25, 1998, available at,.http://www.consumersunion.org/pub/core_newmoney/001937.html

[32] The Fed approved the merger "subject to the condition that Travelers and the combined organization, Citigroup Inc. take all action necessary to conform the activities and investments of Traveler and all its subsidiaries" in a manner "acceptable to the Board, including by divestitures as necessary, within two years. This "two year window" is provided under Section 4(a)(2) of the Bank Holding Act., see, Federal Reserve Press Release, September 23, 1998, available at, http://www.federalreserve.gov/boarddocs/press/bhc/1998/19980923/

[33] For a Reviews of this history see, U.S. Congress. *Gramm-Leach Bliley Act*, Conference Report to Accompany S. 900 H. Rept. 106-434. Printed in the Congressional Record, November 2, 1999; H 11255-H 11303.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Vice Chairman of the emerging Citigroup.[34]

Section 111 of GLBA, known as "Fed-lite," stated that "to the fullest extent possible" the Federal Reserve is directed "to limit the focus and scope" of examinations of bank holding company and their subsidiaries. GLBA severely restricted the ability of the Federal Reserve, or any other agency, to examine, mandate capital restrictions or obtain reports from holding companies or their subsidiaries. [35] The Federal Reserve interpreted the language of GLBA as providing it with limited examination authority of nonbank subsidiaries, including subprime lenders, "because it generally must have specific authority to enforce a consumer protection law in order to examine a nonbank subsidiary for compliance with the law."[36] Each of the twenty-five largest banks, including Bank of America, Citigroup, and JP Morgan Chases, became financial holding companies as defined by GLBA. These holding companies added securitization and mortgage-related assets management units to their portfolios with little financial regulatory oversight. Other financial institutions including, AIG, GE Capital, Merrill Lynch, Lehman Brothers, and Mortgage Stanley, acquired thrifts (formerly known as savings and loans) for the main purpose of originating residential mortgages.

Commodity Futures Modernization Act

Customary banks originated illiquid mortgages and funded them with liquid deposits. Securitization change the model of banking from one of "originate to hold" to one of "originate to distribute." The big five investment firms – Goldman Sachs, Merrill Lynch, Morgan Stanley, Lehman Brothers and Bear Stearns – introduced "mortgage credit derivatives" into the lexicon of global finance by advancing the concept of private sector mortgage securities. Wall Street investment firms packaged individual subprime mortgages into private-label securities, and issued them to investors in the finance

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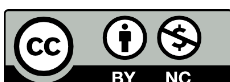
[34] Frontline Transcript, "The Wall Street Fix," www.pbs.org/wgbh/pages/frontline/shows/wallstreet/weill

[35] Section 111 of the Gramm-Leach-Bliley Act: (Public Law 106-102-Novemebr 12, 1999), pp 26-27.

[36] GAO-09-704, footnote 66, p. 37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marketplace as "structured" investment products. Enthralled by the higher yield from the dollar-denominated assets backed by residential mortgages, capital market investors — insurance companies, mutual funds, pension funds and global investors — provided continuing funding for this "shadow banking system."[37] The average estimated daily trading in subprime mortgage securities increased from $60 billion in 2000 to $250 billion by 2006.[38]

Wall Street-supported "originate-to-distribute models" fundamentally transformed the unique relationship between mortgage originators and homeowners, fashioned and cultivated over several decades. Citigroup and Merrill Lynch developed the concept of bundling together a portfolio of mortgage back securities into subprime credit derivatives known as "structured" collateralized debt obligation products (CDO). J.P. Morgan, Merrill Lynch, Citigroup, Goldman Sachs, UBS, and Deutsche Bank advanced more innovative and highly leveraged investment tools in order to fulfill investor demand--including so-called "mezzanine CDO of ABS" (pools of subprime mortgages issued as bonds carrying different degrees of risk).[39]

In his book *The Big Short* Michael Lewis, best-selling author and former Wall Street bond trader, described the process as "towers of debt" comprised of three floors:

> "A basement, called the "equity," which takes the very first losses and is not an investment-grade security; the lower floor, called the "mezzanine," with triple-B rating; and the upper floor, with triple-A rating, and generally referred to as the "senior." In practice, the towers were far more finely sliced: a CDO might have fifteen different tranches, each with a slightly different rating, from triple-B-minus all the way up to

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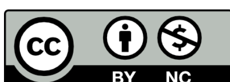
[37] The Preliminary Staff Report, "Shadow Banking and the Financial Crisis, of the Financial Crisis Inquiry Commission defined "*shadow banking* as referring to "bank-like financial activities that are conducted outside the traditional commercial banking system, many of which are unregulated or likely regulated." (Financial Crisis Inquiry Commission 2010), p. 4., available at, http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/2010-0505-Shadow-Banking.pdf

[38] Gretchen Morgenson. "Crisis Looms in Market for Mortgages," *New York Times*. March 11, 2007, available at http://www.nytimes.com/2007/11/15/business/25gret.html.

[39] For review of mortgage credit derivatives see, Gillian Tett (2009) *Fool's Gold* (Chapter Six: "Innovation Unleashed"). Also see, FCIC, Preliminary Staff Report, Credit Derivatives and Mortgage-Related Credit Derivatives, June 29, 2010, available at, http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/2010-0630-psr-credit-derivatives.pdf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Triple-A; triple-B-minus, triple-B, A-minus, A, and so on."[40]

The synthetic CDO market allowed hedge funds, "unregulated investment vehicles that cater to institutions and wealthy individuals", to gain "long exposure" to portfolios of subprime credit derivatives without actual owing any subprime mortgages.[41] On the flipside, the hedge fund often hedged its exposure by "shorting", or betting against the subprime market by purchasing a credit derivative known as the credit-default swap.[42] Subprime mortgage credit derivatives, unlike the majority of derivative contracts, regulated by the Commodities Future Trading Commission (CFTC) were a financial anomaly not classified as securities or insurance contracts. The top banks in the credit default market were JP Morgan Chase, Citibank, Bank of America and Wachovia, along with the top Wall Street investment firms Merrill Lynch, Bear Stearns, Lehman Brothers, and international insurance giant American International Group (AIG).[43]

The Commodity Futures Trading Commission (CFTC) promulgated a concept release seeking comment for the possible regulatory oversight for "opaque and unregulated" over-the-counter (OTC) credit derivatives based on their historical analysis

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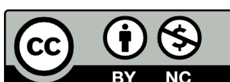
[40] Lewis (2010), pp. 72-74.

[41] At their peak, hedge funds accounted for over fifty percent of all subprime mortgage-related credit derivatives trading. For discussion of the role of Hedge Funds, Credit Derivatives, and Credit Default Swaps, see Charles R. Morris (2008), *The Trillion Dollar Meltdown* (Chapter Six: The Great Unwinding).

[42] For excellent review of how investors "shorted" the subprime market see, Michael Lewis (2010) *The Big Short* (Chapter One: "A Secret Origin Story"). A credit-default swap is a bilateral "side-bets" or "insurance" contract transferring the credit risk on investment of subprime bonds from one party to another for a specified duration. Credit default swaps protected an investor against the loss from par (dollar for dollar) on subprime bond investments in the event of default. Credit-default swaps stipulations and prospective financial impacts were largely hidden form federal regulators. For complete reviews see, New York Times, Topics: "Credit Default Swaps", available at, http://topics.nytimes.com/top/reference/timestopics/subjects/c/credit_default_swaps/index.html

[43] OCC Quarterly Report on Bank Derivatives Activities available at, http://www.occ.treas.gov/topics/capital-markets/financial-markets/trading/derivatives/dq307.pdf



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that these types of derivatives had been "systemically destabilizing" in the past. [44] Members of President Clinton's Working Group, however, articulated "grave concern" because the "OTC derivatives market is a large and important global market." In Congressional testimony, Arthur Levitt, Chairman of the U.S. Securities and Exchange Commission and Treasury Deputy Secretary, Lawrence H. Summer, discarded the notion that CFTC should have regulatory jurisdiction over subprime OTC derivative markets. [45] In a dissenting view, Chairperson Born testified that the CFTC "strongly believes that, in order to carry out its statutory mandate responsibility, it must keep its regulatory system in tune with changes in the markets it oversees." Failure to keep pace, she adds, "would erode the regulatory system ability to protect customers and to preserve the financial integrity" of the OTC credit derivative markets."[46]

Federal Reserve Chairman Alan Greenspan advanced the need for a deregulated OTC market in remarks before the Futures Industry Association, Boca Raton, Florida. "By far the most significant event in finance during the past decade has been the extraordinary development and expansion of financial derivatives," he said, "The fact that the OTC markets function quite effectively without the benefits of [CFTC regulation]

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[44] OTC credit derivatives have been at the heart of systemic or near systemic collapses -- from the 1994 bankruptcy of Orange County, California; to the collapse of Long Term Capital Management in 1998; to the bankruptcy of Enron in 2001. See, CFTC, Over-the-Counter Derivatives, Concept Release (May 7, 1998), available at, http://www.cftc.gov/opa/press98/opamntn.htm. Also see, Michael Greenberger, The Role of Derivatives in the Financial Crisis: Hearings before the Financial Crisis Inquiry Commission, 111th Cong. (June 30, 2010), available at, http://www.fcic.gov/hearings/pdfs/2010-0630-Greenberger.pdf

[45] "Regarding the Regulation of the Over-the-Counter Derivatives market and Hybrid Instrument;" Testimony of Levitt, Chairman U.S. Securities and Exchange Commission Senate Committee on Agriculture, Nutrition, and Forestry on CFTC Concept Release, Arthur Levitt, Chairman U.S. Securities and Exchange Commission, July 30, 1998, available at http://www.sec.gov/news/testimony/testarchive/1998/tsty0998.htm.

See also, Testimony of U.S. Treasury Department Deputy Secretary Lawrence H. Summer, Senate Committee on Agriculture, Nutrition, and Forestry on CFTC Concept Release, Arthur Levitt, Chairman U.S. Securities and Exchange Commission, July 30, 1998, available at, http://www.treasury.gov/press/releases/rr2616.htm

[46] Testimony of Brooksley Born, Chairperson Commodity Futures Trading Commission Concerning the Over-the-Counter Derivatives Market before the U.S. Senate Committee on Agriculture, Nutrition and Forestry, July 30, 1998, available at, http://www.cftc.gov/opa/speeches/opaborn-34.htm

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provides a strong argument for the development of a less burdensome regime for exchange-trade financial derivates."[47] *The Report of the President's Working Group on Financial Markets, Over-the-Counter Derivatives Markets and the Commodity Exchange Act* further expressed concern that "a cloud of legal uncertainty has hung over the OTC derivatives market," which "if not address, could discourage innovation and growth of these important markets and damage U.S. leadership in these arenas by driving transactions off-shore."[48] In order "to promote innovation, competition, efficiency, liquidity, and transparency in OTC derivatives", the report concluded that "it is necessary to provide "legal certainty for OTC derivatives" and remove "impediment to innovation" including the reduction of systemic risk by "removing legal obstacles to the development of appropriately regulated clearing systems."[49]

Michael Greenberger, Professor at the University of Maryland School of Law and former Director of Trading and Markets at the CFTC, outlines how on the Senate floor, Senator Phil Gramm, Chairman of the Senate banking committee, "rushed through a 262-page rider to an 11,000-page omnibus appropriations bill on Dec. 15, 2000 -- the last day of a lame-duck session."[50] Senator Gramm included this provision, the Commodity Futures Modernization Act (CFMA), to "protect financial institutions from overregulation" and "position our financial services industries to be world lenders into the new century." In "one fell swoop", according to Greenberger, "the OTC market was exempt from the traditional market regulatory controls, including capital-adequacy

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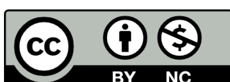
[47] Remarks of Federal Reserve Chairman Alan Greenspan, *Financial Derivatives*, before the Futures Industry Association, Boca Raton, Florida (March 19, 1999).

[48] *Report of the President's Working Group on Financial Markets, Over-the-Counter Derivatives Markets and the Commodity Exchange Act*, November 1999, available at, http://www.treasury.gov/resource-center/fin-mkts/Documents/otcact.pdf

[49] Ibid

[50] Michael Greenberger, "Out of the Black Hole, Reining in the Reckless Market in over-the-counter derivatives," *The American Prospect*, April 26, 2010, available at, http://prospect.org/article/out-black-hole-0; and also see Michael Greenberger, former Director of Trading and Markets at the CFTC, interview on National Public Radio Terry Gross Show, April 3, 2008, available at, http://www.npr.org/player/v2/mediaPlayer.html?action=1&t=1&islist=false&id=89338743&m=89338809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requirements; reporting and disclosure; regulation of intermediaries; supervised self-regulation; and bars on fraud and manipulation. Overnight, the entire OTC market was legitimized as a private market, wholly opaque to financial regulators and market observers."[51] On December 21, 2000, in one of his last acts as President, Bill Clinton signed into law the Commodity Future Modernization Act of 2000.[52]

In a PBS Frontline interview, a decade after leaving the CFTC, Brooksley Born said the President's Working Group antagonism was puzzling, "what was it that was in this market that had to be hidden?" Some people, she adds, "really were purists in terms of belief in free markets and were absolutely, from a doctrinal point of view, opposed to regulation." Others she said "were concerned with keeping the big banks and investment banks happy and making sure that they were responsive to the demands of those entities, additionally, "one thing we have to remember is that the financial services industry was the largest campaign finance contributor" and "was very effective in lobbying the executive branch and Congress."[53]

The Deleveraging of the Shadow Banking System

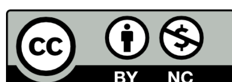
In an often quoted 2002 letter to Berkshire Hathaway shareholders, Warren Buffett, the legionary investment banker, famously called OTC credit derivatives "financial weapons of mass destruction, carrying dangers" which, while then latent, were "potentially lethal." Buffett warned of the "mega-catastrophic risk" posed by the growing trade in derivatives:

> [We] are of one mind in how we feel about derivatives and the trading activities that go with them: we view them as time bombs, both for the parties that deal in them and the economic system…I can assure you that the marking errors in the derivatives business have not been symmetrical. Almost invariably, they have favored either the

[51] Ibid.

[52] Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763.

[53] *Frontline: The Warning* (PBS television broadcast interview), October 20, 2009, available at, http://www.pbs.org/wgbh/pages/frontline/warning/interviews/born.html



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trader who was eyeing a multi-million dollar bonus or the CEO who wanted to report impressive "earnings" (or both)."[54]

The "Quants of Wall Street" (algorithmic traders whose ranks included brokerage firm trades, hedge funds managers and academics with mathematical backgrounds) developed investment strategies that appeared, at least in the early stages of securitization, to be a robust predictor of investment risks for subprime mortgage products. [55] In the end, however, Wall Street mortgage innovations were a debacle in their execution.[56] As noted by the research of Laurie Goodman, Managing Director and co-head of Global Fixed Income Research at UBS, and her colleagues, it was the short-rest hybrid [2-28 and 3-27 subprime mortgage products], simultaneous silent second mortgages (0% down), stated income (liar's) loan that created all the havoc. In a normal world, she said, "such loans would never have been created. No one in the subprime industry believes that type of loan should have been the mainstay of the market. Everyone knew it was an accident waiting to happen. They just did not comprehend the magnitude of the coming crack-up."[57] The number and percentage of subprime mortgages in default or foreclosure rose sharply to levels at or near historical highs.[58]

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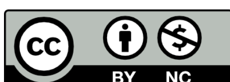
[54] Warren Buffett, 2002 letter to shareholders, http://www.bershirehathaway.com/letters/2002pdf.pdf

[55] Wall Street Journal report Scott Patterson provides an excellent overview of major plays and their role in subprime investment strategies in his book, *The Quants: How a New Breed of Math Whizzes Conquered Wall Street and Nearly Destroyed It*. Also see Wall Street Journal (Book) January 22, 2010, "The Minds Behind the Meltdown: How a Swashbuckling breed of mathematicians and computer scientists nearly destroyed Wall Street", available at, http://online.wsj.com/article/SB10001424052748704509704575019032416477138.html

[56] Beginning in 2006, an over half century pattern of home prices going up had reversed. For the first time, housing prices began to decline in all regions of the country. As housing prices flattened or declined, subprime mortgage interest rate resets caused homeowners to become "underwater," where their mortgage was greater than the value of the home.

[57] Lurie S. Goodman, Shumin Li, Douglas J. Lucas, et al. (2008). *Subprime Mortgage Credit Derivative*s. p. 304

[58] GAO, Home Mortgage Defaults and Foreclosure: Recent Trends and Associated Economic and Market Developments, Briefing to the Committee on Financial Services House of Representatives, October 10, 2007, available at, http://www.gao.gov/new.items/d0878r.pdf



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Rising mortgage defaults and foreclosures resulted in a liquidity drought forcing subprime companies to close their doors and file for bankruptcy.[59] The complexity of subprime mortgage credit derivates underlying transactions as well as the uncertainty regarding the level of subprime foreclosures made securities difficulty to value. As the subprime sector imploded, the market for mortgage credit derivates vanished. Subprime exposure resulted in downgrades for bond insures that would have consequences across the financial system. The rating agency S&P provided an early warning of things to come when it announced it had placed over six hundred tranches backed by subprime credit derivatives, an estimated $7.4 billion, on negative watch.[60] Over time, rating agencies downgraded multi-billions of dollars of Wall Street triple-A subprime securities to junk status.[61] Several systemically important financial institutions that defines the term "too big to fail" remained significantly exposed. Global financial institutions like Bear Sterns, Citibank, Goldman Sachs, and Morgan Stanley, lacking liquidity, were bailed out, or struggling. [62]

Losses experienced by highly leveraged subprime financial intermediaries would soon cascade from Wall Street to global capital markets. European banks suffered nearly one trillion dollars in subprime related losses. The bailout of the Germany financial giant

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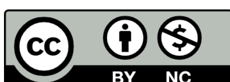
[59] For examples, on April 2, 2007, New Century Financial closed its doors and files for bankruptcy. In the same year, leading subprime mortgage companies Fremont General, Nova Star, American Home Mortgage, and Aegis Mortgage filed for bankruptcy. Washington Mutual announced that it expected to terminate the jobs of 3,000 employees' as a result of investments in subprime mortgage-backed securities and reported fourth quarter loan losses would reach $1.6 billion.

[60] PR Newswire, "Various U.S. First-Lien Subprime RMBS Classes Downgraded," July 12, 2007, p.2, available at, http://www.prnewswire.com/news-releases/various-us-first-lien-subprime-rmbs-classes-downgraded-52731227.html

[61] Statement of Senator Carl Levin, Exhibit 1i, available at: http://hsgac.senate.gov/public/_files/Financial_Crisis/042310Exhibits.pdf

[62] For example, on September 21, 2008, the Federal Reserve Board took the extraordinary step of approving the application of Morgan Stanley and Goldman Sachs to become bank holding companies, with full assets to "cheap money" available at the Federal Reserve discount window.
Federal Reserve Press Release, September 21, 2008, available at, http://www.federalreserve.gov/newsevents/press/bcreg/20080921a.htm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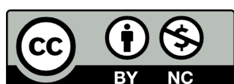
IKB was one of the first indicators of the global ramification. In swift succession, HSBC Holdings PLC, Europe's biggest bank, the large U.K. banks, Barclays and Northern Rock, the large French bank, BNP Paribas, the Swiss bank giant UBS, the largest wealth manager in the world, and even the Bank of China reported major losses from their multi-billion dollar portfolios of mortgage backed-securities and "impairment charge" related to subprime investments. [63] Then on September 15, 2008, the large Wall Street investment firm Lehman Brother filed the largest Chapter 11 bankruptcy in the history of the United States. The insolvency of Lehman triggered a global liquidity crisis.

The Rescue of AIG

Surmising that American International Group (AIG) was so interconnected to other actors in the financial sector that its potential failure created systemic risk, the Federal Reserve Board used its "unusual and exigent circumstances" authority under section 13 (3) of the Federal Reserve Act to led a $85 billion government rescue of AIG.[64] The New York Fed established two new lending facilities with the authority to lend up to $22.5 billion to purchase residential mortgage-backed securities and $30 billion to purchase subprime-related credit derivatives on which AIG has written credit default swaps contracts. AIG counterparties who purchased "protection" included Goldman Sachs, Merrill Lynch, Bank of American and a number of other top tier global

[63] Reuter. "UBS Post Larger-than-Expected Loss," New York Times. October 31, 2007, available at http://www.nytimes.com/reuters/business/business-ubs-results.html ; Reuter. "Barclays to Write Down $2.7 Billion," New York Times. November 15, 2007, available at http://nytimes.com/reuters/business/business-barclays-trading.html; and Bloomberg News. "Bank of China Reports Heavy Exposure to Subprime Crisis," New York Times, August 24, 2007, available at http://www.nytimes.com/2007/08/24/business/worldbusiness/24wire-china.html

[64] According to the Board of Governors Press Release: "The Board determined that, in current circumstances, a disorderly failure of AIG could add to already significant levels of financial market fragility and lead to substantially higher borrowing costs, reduced household wealth, and materially weaker economic performance. The purpose of this liquidity facility is to assist AIG in meeting its obligations as they come due. This loan will facilitate a process under which AIG will sell certain of its businesses in an orderly manner, with the least possible disruption to the overall economy." Board of Governors of the Federal Reserve System, Press Release, September 16, 2008, available at: http://www.federalreserve.gov/newsevents/press/other/20080916a.htm



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investment banks.[65] The New York Fed agreed to reimburse AIG counterparties contracts at par value. This meant that Wall Street investment firms received billions from their subprime related investment losses without taking a deduction in market value or "haircut" costing taxpayer more than $182 billion.[66]

According the testimony of Federal Reserve Bank of New York Executive Vice President and General Counsel Thomas C. Baxter, "with bankruptcy not an option, it was necessary to find a solution that stemmed the liquidity drain arising from the continuing collateral calls on the CDS contracts, stabilized AIG and protected the taxpayer interests." [67] On why the New York Federal Reserve did not insisted on AIG counterparties taking a "haircut" on the credit default swaps, he explained, "AIG bankruptcy under the economic conditions existing in the fall of 2008 would have had catastrophic consequences for our financial system and our economy." The New York Federal Reserve General Counsel testified:

"The Federal Reserve has been criticized by some for not using its regulatory power to force the counterparties to accept less money for the CDOs. The critics overlook a number of key factors…First, there was little time, and substantial execution risk and attendant harm of not getting the deal done by the deadline…When the Federal Reserve

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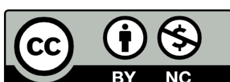
[65] AIG counterparties who purchased "protection" included Goldman Sachs ($8.4 billion), Merrill Lynch ($6.8 billion), Bank of American ($5.2 billion), Citigroup ($2.3 billion), the foreign banks Societe Generale ($9.6 billion), and Deutsche Bank ($5.7 billion). For complete his of payment to AIG Counterparties, see , see *Financial Crisis Inquiry Commission Final Report on the Causes of the Financial Crisis*, *Figure 20.4*, p. 377, available at www.fcic.gov

[66] For details of New York Fed actions see, Reuters, "Federal Reserve Statement on AIG," November 10, 2008, available at: http://www.reuters.com/article/idUSTRE4A929Y20081110

[67] Federal Reserve Bank of New York Executive Vice President and General Counsel Thomas C. Baxter testified that: "the policy decision to authorize a loan to AIG was a difficult one, because addressing the systemic crisis facing the United States required the Federal Reserve to assist a private company at the center of the risks that led to the crisis. Nonetheless, the potentially far-reaching consequences of an AIG bankruptcy compelled policymakers to take affirmative action. The failure of AIG in the fall of 2008 would have imposed significant financial losses on many individuals, households and businesses, shattered confidence in already fragile financial markets, and greatly increased fear and uncertainty about the viability of our financial institutions, see, Thomas C. Baxter Jr., Executive Vice President and General Counsel the Federal Reserve Bank of New York, testimony before the Committee on Government Oversight and Reform, U.S. House of Representative, *Factors Affecting Efforts to Limit Payments to AIG Counterparties*, January 27, 2010, available at, http://www.newyorkfed.org/newsevents/speeches/2010/bax100127.html



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reached out to AIG's counterparties, we believed, based on AIG's own experience, that our probability of success of getting them timely to agree to concessions was slim... Even in a best-case scenario, we did not expect that the counterparties would offer anything more than a modest discount to par…

Some have said that, in the absence of other bargaining power, the Federal Reserve should have used its regulatory power—threatening an adverse use of that power, or suggesting some kind of a benefit flowing from it—to make regulated counterparties give up or compromise their contractual rights. We see that as an abuse of regulatory power. ***The idea that the Federal Reserve would threaten a financial institution with supervisory action when no grounds for such action exist***, or give a financial institution special treatment simply to gain an advantage in a commercial transaction is, in our view, an abuse of our authority. Such conduct by the Federal Reserve might have generated bargaining power over the counterparties, but it is simply inconsistent with the rule of law" (emphasis added).[68]

Michael Lewis, a vocal critic of the New York Fed agreement, vigorously denounced the terms of the AIG bailout. Here is an amazing fact, he writes, that "after perhaps the most sensational corporate collapse in the history of finance, a collapse that, without the intervention of the government, would have led to the bankruptcy of every major American financial institution, plus a lot of foreign ones, the bailout of AIG has not been appropriately clarified." "How could the U.S. government simply hand over $54 billion in taxpayer dollars to Goldman Sachs and Merrill Lynch and all the rest to make good on the subprime insurance A.I.G. F.P. had sold to them—especially after Goldman Sachs was coming out and saying that it had hedged itself by betting against AIG?"[69]

Conclusion

The nature and depth of the financial crisis is forcing a reexamination of some basic tenets of financial theory. Before the financial crisis, for decades, mainstream economic theory passionately asserted that the financial market work best guided by the

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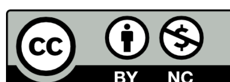
[68] Ibid.

[69] Michael Lewis, The Man Who Crashed the World, Vanity Fair, June 30, 2009, available at, http://www.vanityfair.com/online/daily/2009/06/the-man-who-crashed-the-world. For an excellent overview of events leading to the AIG bailout, see McLean and Nocera (2010), Chapter 21: Collateral Damage.



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"invisible hand" of markets free from governmental regulatory oversight. In this view, shared by politicians on both sides of the aisle, the optimal mechanism for rational and productive market outcomes is restrain of government control and market regulation. Culpability for the collapsing architecture of the financial sector, including those affecting housing, has shifted on actions most principally of Wall Street, not federal housing policy. Celebrated libertarian thinker Richard Posner, a judge of the United States Court of Appeal for the Seventh Circuit called the financial crisis a *failure of capitalism* rather than a *failure of government*. The critical role of the government in the financial crisis, he said, was "one of permission rather than of encouragement." Judge Posner providers a decisive synopsis of the "Big Lie" narrative:

> Some conservatives believe that the depression is the result of unwise government policies. I believe it is a market failure. The government's myopia, passivity, and blunders played a critical role in *allowing* the recession to balloon into a depression, and so have several fortuitous factors. But without any government regulation of the financial industry, the economy would still, in all likelihood, be in a depression. We are learning from it that we need a more active and intelligent government to keep our model of a capitalist economy from running off the rails. The movement to deregulate the financial industry went too far by exaggerating the resilience-the self-healing powers-of laissez-fair capitalism. [70]

Former Federal Reserve Chairman Alan Greenspan, one of the most noteworthy advocates of financial deregulation, told Congress that the financial crisis had left him in a "state of shocked disbelief" and that he had been "partially wrong." Greenspan said, "I discovered a flaw in the model that I perceived is a critical functioning structure that defines how the world works. I have been going for 40 years with considerable evidence that it was working exceptionally well. However, "I was wrong to think that free markets could regulate themselves without government oversight." [71] During the hearing,

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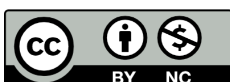
[70] Richard A. Posner (2009). A Failure of Capitalism: The Crisis of '08 and the Descent into Depression Harvard University Press, p. xii

[71] Mark Felsenthal, "Greenspan 'shocked' at credit system breakdown," Reuters, October 23, 2008, available at http://www.reuters.com/article/idUSTRE49M6CK20081023; Kara Scannell and Sudeep Reddy, "Greenspan Admits Errors to Hostile House Panel," *Wall Street Journal*, October 24, 2008, available at http://online.wsj.com/article/SB122476545437862295.html; and NPR, Greenspan Admit Free Market Ideology Flawed, available at, http://www.npr.org/templates/story/story.php?storyId=96070766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Republican lawmakers make every effort to place primary blame on the "unchecked growth of Fannie Mae and Freddie Mac", but "Mr. Greenspan placed far more blame on the Wall Street companies that bundled subprime mortgages into pools and sold them as mortgage-backed securities." [72]

In hindsight, "there's no question that we would have been better off if we had been regulating derivatives", a former general counsel for the SEC said in a 2008 Washington Post interview. [73] In the article, SEC Chairman Levitt remarked that in "fairness while [Member of President Working Group]Summers and Rubin and I certainly gave in to this, we were not in the same camp as the Fed," he said, "the Fed was really adamantly opposed to any form of regulation whatsoever. I guess if I had to do it over again, I would have pushed for some way to give greater transparency" to OTC credit derivatives "which turned out to be injurious to our markets."[74] As noted by MIT Professor Simon Johnson, in the influential text *13 Bankers*, "never before has so much taxpayer money been dedicated to save an industry for the consequence of its own mistakes. In the ultimate irony, it went to an industry that has insisted for decades that it had no use for government and would be better off regulating itself-and it was overseen by a group of policymakers who *agreed* that government should play little role in the financial sector."[75]

Five years after the financial crisis, even though at odds with the facts of observation, the most orthodox supporters of the "Big Lie" doctrine remain unyielding defenders. In truth, as revealed throughout this essay, the government intervention "Big

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[72] Edmund L. Andrews, *Greenspan Concedes Error on Regulation*, New York Times, October 23, 2008, available at, http://www.nytimes.com/2008/10/24/business/economy/24panel.html

[73] What Went Wrong; How did the World's Markets Come to the brink of collapse? Some say regulators failed. Others claim Deregulation left them handcuffed. Who's Right? Both are. This is the story on how Washington didn't catch up to Wall Street, Washington Post, October 15, 2008, available at, http://econweb.umd.edu/~mendoza/econ442/news_files/what%20went%20wrong.pdf

[74] Ibid.

[75] Simon Johnson and James Kwak (2010), *13 Bankers; The Wall Street Takeover and the Next Financial Meltdown,* p. 164.

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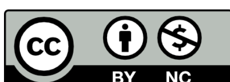
Lie narrative" is unpersuasive because it discounts the role of Wall Street. This "Big Lie" narrative is also a distraction in its shrewdness. It diverts attention away from the role of financial deregulation and the need for Wall Street reforms, while placing far too heavy a burden on the homeownership ambitions of traditionally underserved communities as a principal source for a multi-trillion dollar global credit crisis.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