A Breakdown in the Good of Order: An Analysis of the Subprime Mortgage Crisis Informed by Bernard Lonergan's Notion of the Human Good

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A BREAKDOWN IN THE GOOD OF ORDER: AN ANALYSIS OF THE SUBPRIME MORTGAGE CRISIS INFORMED BY BERNARD LONERGAN’S NOTION OF THE HUMAN GOOD

a dissertation

by

JOSEPH RICHARD CIONI

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Abstract

A Breakdown in the Good of Order: An Analysis of the Subprime Mortgage Crisis
Informed by Bernard Lonergan’s Notion of the Human Good

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Advisor: Professor Patrick Byrne

In this dissertation, I attempt to contribute to Lonergan scholarship by bringing greater clarity to his notions of general and group bias. By applying these notions to a concrete event, the subprime mortgage crisis, I intend to shed light on their meaning and significance in a new way. Over the course of this dissertation, I will investigate and employ other theoretical tools that Lonergan provides, such as his notions of transcendental method, self-appropriation, common sense, and values, and especially the destructive impact of group and general bias upon the good of order. The theoretical ideas that are examined in this dissertation have a heuristic value, for they have the potential to help individuals notice areas and respond to issues that might have otherwise been overlooked.

The subprime mortgage crisis, which arguably began when American house prices dropped in July of 2006, was the product of an accumulation of biased decisions over time. Lonergan’s notion of the general bias of common sense afflicted many of the central parties involved in the subprime mortgage market leading up to the crisis, prompting them to conclude that house prices would interminably rise. Institutional relationships that were impaired by this biased orientation toward the housing market came to be further plagued by Lonergan’s notion of group bias. Ultimately, I argue that subprime mortgage crisis was a manifestation of a breakdown in the good of order, which is a component of Lonergan’s notion of the invariant structure of the human good.
Chapter One consists of a presentation and explication of the set of Lonergan’s theoretical tools that are utilized in this study. The chapter begins with an exploration of his transcendental method and then proceeds with a discussion that includes his notions of cognitional structure, self-appropriation, common sense, values and judgments of value, conversion, self-transcendence, authenticity, bias, and the invariant structure of the human good.

Chapter Two serves a bridge between these theoretical terms and my analysis of the parties that were involved in the subprime mortgage crisis. In addition to arguing that the general bias of common sense distorted the decision making processes of many of the significant players in the subprime mortgage market, I will also contend that group bias was operative leading up to and during this crisis. The emphasis in this latter section will be on instances of “co-opted” group bias, or arrangements in which different parties cooperated with one another in mutually advantageous ways in the short-term, but to the detriment of the good of order.

Chapters Three through Six each focus on one of the parties that played an instrumental role in the development and outbreak of the subprime mortgage crisis: subprime lenders (Chapter Three), arrangers (Chapter Four), credit rating agencies (Chapter Five), and Fannie Mae and Freddie Mac (Chapter Six). I examine key regulatory relationships in these chapters as well and note that, in many cases, they were ensnared by general and group bias. My concluding analysis is that, as an accumulation of biased decisions, the subprime mortgage crisis was an avoidable outcome, for individual submission to bias is not inevitable.
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To my parents, Rock and Susan Cioni; and grandparents Skip and Dotty Squires

And in loving memory of my grandparents, Richard J. Cioni, Sr. and Helen M. Cioni
Introduction

Homeownership, for many Americans, has come to be associated with prosperity, success, freedom, security, and independence. Consider this advertisement that accompanied an article in *Scribner’s Magazine* entitled “A Hundred Thousand Homes: How They Are Paid For,” written in 1876:

Fourth of July! Independence Day! Young man and woman, stop and reflect! The money you fritter away uselessly will make you independent. Today sign the magna chart of your independence, and, like our forefathers, in about eight years you will, in a great degree, be independent by saving only thirty-three cents each day. In that time you will realize $2,000, or have a home and be independent of the landlord.¹

In 1892, Seymour Dexter, the founder and first president of the United States League of Local Building and Loan Associations, declared, “It is a firm conviction with me that the future of the Republic depends upon the question [of] whether we can make this nation a nation of homeowners or not.”² Tellingly, the league’s first motto was “The American Home: The Safeguard of American Liberties.”³ Five years later, in 1897, Dexter described the ideal American home as being one that is “a comfortable modern home surrounded by a large lawn in which children are at play.”⁴ Additional images invoked by Dexter in his depiction of this home included “a little daughter running to greet her

² Ibid., 40.
³ Ibid.
⁴ Ibid.
approaching father,” and both a church spire and a New England schoolhouse nestled in foliage in the distance, the latter of which was bearing a waving American flag in front.\(^5\)

This enthusiastic promotion of homeownership in the late nineteenth century certainly was not an American historical anomaly. Over 100 years later on June 17, 2004, President George W. Bush delivered a speech that echoed Dexter’s affirmation of the importance of homeownership by way of supporting an “ownership society.” Bush reasoned that “…if you own something, you have a vital stake in the future of our country. The more ownership there is in America, the more vitality there is in America, and the more people have a vital stake in the future of the country.”\(^6\) Bush demonstrated support for American homeownership by promoting the American Dream Downpayment Initiative, which offers assistance with down-payments on homes to over 40,000 low-income American families. Furthermore, Bush proposed the Single-Family Affordable Housing Tax Credit, which aimed to increase the supply of affordable homes in the United States. He also declared that there is a dual-need for the simplification of the home buying process and the expansion of financial education, both of which share the end of helping Americans understand what is involved in being a homeowner.\(^7\)

It is interesting that Bush incorporated the phrase “American Dream,” originally coined by James Truslow Adams in his 1931 book *The Epic of America,*\(^8\) in describing an initiative that aims to make homeownership more available to those who are typically

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\(^5\) Ibid.

\(^7\) Ibid.

\(^8\) John Truslow Adams, *The Epic of America* (Boston: Little, Brown and Company, 1950), 374. Writing in the midst of the Great Depression, Adams does not include the notion of widespread homeownership in his vision of the American Dream. Still, he does say that the American Dream is “the dream of a land in which life should be better and richer and fuller for every man, with opportunity for each according to his ability or achievement.”
unable to afford a home. Homeownership has become central to the American Dream. Collectively, the idea seems to be that the more homeownership that there is in America, the more America will have invested citizens who will care about the health of the country, since they have more at stake than non-homeowners. Owning a home provides security to one’s family and represents success, while collective homeownership contributes to the security of the country and displays its high standard of living.

Given the salience of this value in America, it was not surprising to observe the shockwaves that were sent throughout the nation as the subprime mortgage crisis began to unfold. A vital and cultural value was being and continues to be threatened as more and more homes slip into foreclosure. In 2007, 405,000 households lost their home, an increase of 51% from the figure of 268,532 in 2006. Delinquency rates among subprime mortgages rose from 10.27% at the end of the first quarter in 2004 to 14.27% at the end of the fourth quarter of 2006. By 2011, 11.1 million American homeowners owed more on their mortgages than their homes were worth. In the first quarter of 2012, 7.4% of the nation’s mortgages were either 90 days or more past due or in foreclosure, approximately 335% higher than the average throughout the 1990’s. CoreLogic glumly estimates that there were approximately 3 million foreclosures that were completed over the course of 2009-2011.

Nor is this crisis limited to those who took out subprime mortgages. Indeed, part of what is so alarming about the present housing crisis is the degree of collateral damage

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12 Ibid., 11.
that has occurred. If one has a house that forecloses in a given neighborhood, it can cause the values of neighboring houses to drop as well. The Center for Responsible Lending estimates that 40.6 million neighboring homes “will experience devaluation because of subprime foreclosures that take place nearby,” with an average loss of around $5,000 per household.\(^\text{13}\) Decreased property values also increase the likelihood of neighborhood instability as well as reduce the amount of tax revenue that a city can generate for public projects. Baltimore, which has already lost tens of millions of dollars in subprime-related foreclosures, sued Wells Fargo for allegedly targeting black borrowers, offering them high-risk and unfairly priced home loans.\(^\text{14}\) The City of Cleveland, provocatively, filed a public nuisance lawsuit against 21 investment banks for facilitating subprime-related losses in the city.\(^\text{15}\) Added to this fray is the rise of \textit{intentional} foreclosures, ones that take place not because borrowers are unable to afford the monthly mortgage payments, but because they simply no longer want to pay the loan back, given that their property has dropped in value and, perhaps, the value of the property is now worth less than the remaining amount that needs to be repaid.\(^\text{16}\) Other factors exacerbating the volatile American housing market include the first-ever year over year drop in the median price of houses (since reliable records began to emerge around 1968),\(^\text{17}\) and a “shadow inventory” of 1.5 million homes that are either seriously delinquent, in the foreclosure


process, or real estate owned (REO) that are not listed for sale.\textsuperscript{18} Homes owned by a lender that were acquired by foreclosure or similar means are known as REO.\textsuperscript{19}

It is hard to determine how much of an impact the subprime mortgage crisis has had on our economy as a whole. According to The Federal Deposit Insurance Corporation (FDIC), there were 25 bank failures in 2008, 140 bank failures in 2009, 157 bank failures in 2010, 92 bank failures in 2011, and 31 bank failures over the first six months of 2012.\textsuperscript{20} To put the magnitude of these bank failures in perspective, there were only 27 bank failures over the course of 2000-2007.\textsuperscript{21}

From December of 2007 to June of 2009, household income in the United States fell 3.2\%.\textsuperscript{22} Inflation-adjusted median household income fell another 6.7\% from June 2009 to June 2011.\textsuperscript{23} In April of 2012, the unemployment rate stood at 8.1\%\textsuperscript{24} with approximately 13.7 million jobless workers in the United States.\textsuperscript{25} Before the outbreak of the subprime mortgage crisis in 2007, people who were long-term unemployed, those who were looking for work for more than six months, accounted for 0.8\% of the

\textsuperscript{18} “CoreLogic Reports Shadow Inventory Fell in April 2012 to October 2008 Levels,” The New York Times (June 14, 2012).
\textsuperscript{21} Ibid.
\textsuperscript{23} Ibid.
American labor force. By 2010, the long-term unemployed accounted for 4.2 percent of the work force, a number that does not even include those who gave up looking for work. Indeed, the U6 unemployment rate, which includes not only those who are unemployed and seeking full-time employment, but also those who are working part-time (and desire full-time employment) as well as those who are unemployed and discouraged, having given up on looking for employment, was at 14.7% as of August of 2012. From July of 2007 to August of 2012, the average monthly U6 unemployment rate was 14.9%. Significantly, as Binyamin Appelbaum has noted, “People who lose jobs, even if they eventually find new ones, suffer lasting damage to their earnings potential, their health and the prospects of their children. And the longer it takes to find a new job, the deeper the damage appears to be.” One poll in *The New York Times* revealed that 81% of respondents feel that the United States is headed on the wrong track, and 78% indicated that they feel that the nation is worse off now than it was five years ago.

My aim in writing this work is to unpack the phenomenon of the subprime mortgage crisis by relying upon a selected set of theoretical tools that Bernard Lonergan presents in his writings. The first chapter will consist of a presentation and explication of this set of tools. The chapter will begin with an exploration of his transcendental method. Lonergan’s notions of emergent probability, schemes of recurrence, cognitional structure

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27 Ibid.
28 This information was acquired at the Portal Seven database, available at http://portalseven.com/employment/unemployment_rate_u6.jsp#.
and the self-correcting process of learning, bias, positions and counterpositions, common sense, and the invariant structure of the human good will all be explored as well.

The second chapter of this dissertation will serve as a bridge between Lonergan’s theoretical tools and an analysis of the subprime mortgage crisis. I will begin this chapter by briefly presenting the findings of a report published by two senior economists at the Federal Reserve Bank of Boston and one research economist at the Federal Reserve Bank of Atlanta. The authors of this report argue that “bubble fever,” or what Lonergan would call general bias, impaired the decision making processes of many of the major players in the subprime mortgage market. I will focus on borrowers and investors as portrayed in this report. I will continue this section by providing a sketch of how group bias was operative leading up to and during the subprime mortgage crisis. The emphasis in this section will be on instances of “co-opted” group bias, or arrangements in which different parties cooperated with one another in mutually advantageous ways, but to the detriment of the good of order.31 The five relationships of this sort that will be covered briefly in this subsection are: lenders and their federal regulators, lenders and arrangers, arrangers and the Securities and Exchange Commission, arrangers and the credit rating agencies, Fannie Mae, Freddie Mac and Congress.

To help provide a context for the later chapters on the different parties involved in the crisis, I will call attention to how a federally accepted definition of the term

31 To be sure, many of the parties of the subprime mortgage crisis fell prey to group bias without having to cooperate with a separate party. Goldman Sachs’ relationship with AIG, for example, was unquestionably beneficial to them, but disastrous for AIG and, later, American taxpayers. Importantly, this “individual” form of group bias is implicit in the “co-opted” form. The way in which the Office of Thrift Supervision grossly under-regulated Washington Mutual was, in the short-term, mutually beneficial, but the driving force behind this under-regulation was simply group bias: the Office of Thrift Supervision generated fee revenue and enhanced the perception of its regulatory relevance, while Washington Mutual was able to recklessly take on risks that were immensely profitable in the short-term. Absent those fundamental benefits, the “co-opted” form of group bias would have never come into being.
“subprime” never emerged before or during the subprime crisis, which likely made it difficult to effectively regulate the subprime mortgage market. Next, I will unpack the important distinction between the primary and secondary market. I will then examine a few of the historical preconditions that were in place that later created conditions for the subprime mortgage market to flourish. Among the most prominent of these preconditions was the Savings and Loan Crisis, which, like the subprime mortgage crisis, was plagued by the general bias of common sense. Finally, I will present an account of the original subprime mortgage crisis that erupted in the late 1990’s. This crisis accentuated the riskiness of subprime loans and the fragile interconnectedness of participants in the financial markets. For these reasons, this original subprime crisis should have triggered an alarm that subprime loans merited stricter oversight. Yet, general bias and group bias reared their head once again in the early 2000’s as the profit potential of the subprime mortgage market proved to be too tempting to many large market participants.

In the third chapter, I will investigate the first of five parties that were involved in the subprime mortgage crisis: the lenders. This chapter will begin by untangling the fragmented and intricate nature of mortgage banking regulation in the United States and then move into an argument that this regulatory apparatus was ill-equipped for providing sound oversight of subprime lenders. After investigating whether certain types of lenders are distinct enough to warrant the complicated regulatory structure that was in place, I will specify how involved each type of lender was in the subprime mortgage market. Next, I will discuss the importance of the advent of securitization and then examine certain deregulatory preconditions, both of which made the explosion of subprime lending in the early 2000’s possible. I will then raise the question of how effectively the
Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS) were able to regulate their lenders and protect borrowers in light of the fact that they competed with one another for charters and preempted crucial state consumer protection laws. In order to make this latter discussion more concrete, I will provide a snapshot of the OCC and OTS in action: the former with respect to Wells Fargo Home Mortgage and Chase Home Finance, and the latter with respect to Washington Mutual. After providing a summary of their regulatory failure, I will turn to the third federal regulator of lenders, the Federal Reserve. I will argue that the Federal Reserve absolved themselves of their responsibility to oversee non-depository mortgage lending affiliates, which created an enormous regulatory blind spot. To substantiate this latter point, I will examine the Federal Reserve’s relationship with Countrywide Home Loans. Finally, I will discuss how the fourth type of regulator, state regulators, were overwhelmed by the size and complexity of large subprime lenders like Ameriquest and New Century Financial.

In chapter four, I will investigate the role that the five largest investment banks, the arrangers, played in the subprime mortgage crisis. Included in this chapter will be an argument that the subprime mortgage boom in the early 2000’s was instigated, at least in part, by a supply-side, arranger-fueled demand for subprime mortgages, which is exemplified by the fall of Lehman Brothers. I will then explore the multiple roles that arrangers played in the subprime securitization process and follow up this discussion with a thumbnail sketch of collateralized debt obligations. Next, I will chronicle the spectacular collapse of “the Wal-Mart of the CDO [collateralized debt obligation]
industry,“32 Merrill Lynch. Shifting gears, I will examine the Securities and Exchange Commission’s misguided and ill-fated adoption of the alternative net capital rule and their creation of the regrettable consolidated supervised entities program. These decisions created conditions for arrangers to go on a leverage binge, which, when coupled with an overreliance on a short-term funding source (repurchase agreements), led to the swift and sensational decline of all five arrangers once house prices declined. The collapse of Bear Stearns is a paragon of this unreasonable regulatory arrangement and irresponsible business practice. The five arrangers were attracted to credit-default swaps (CDSs), so it is necessary to explain the basis of this attraction as well as describe the nature of these contracts. I will then explore the breathtaking fall of the largest CDS protection seller, AIG, and show how they were blinded by general and group bias. In the final two sections, I will examine the decline of “the gold standard” in investment banking, Goldman Sachs, and Morgan Stanley.

In chapter five, I will focus on the lynchpin of the subprime mortgage crisis, the credit rating agencies. I will begin this section by providing a brief history of credit ratings in the United States and then an explanation of the function of the credit rating agencies. Next, I will provide an analysis of the credit rating industry and then consider various criticisms that have been leveled against the three largest credit rating agencies, ultimately arguing that they were in a position to privilege volume over accuracy when it came to their ratings. By privileging volume, those three credit rating agencies stood to make large sums of money in exchange for inundating the investing community with financial product of (at best) questionable credit risk.

32 Serena Ng and Carrick Mollenkamp, “Merrill Takes $8.4 Billion Credit Hit --- It Plunged Into CDOs In '03, Hiring Pioneer Of the Debt Securities,” The Wall Street Journal (October 25, 2007).
Chapter six will consist of an exploration of the two housing government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac, and their contribution to the subprime mortgage crisis. First, I will provide a brief history of the enterprises and then explain what the term “government sponsored enterprise” means. Next, I will argue that Fannie Mae and Freddie Mac were the recipients of an implicit government guarantee of their debt obligations, which enabled them to receive a unique subsidy from the federal government. After examining the two lines of business that Fannie Mae and Freddie Mac conduct in the mortgage market, I will explain why one is riskier and more profitable than the other. Both of the housing GSEs were embroiled in a scandal in the early 2000’s, which created an opportunity for Congress to strengthen their regulatory oversight of them. I will argue that Fannie Mae and Freddie Mac successfully evaded any meaningful regulatory restrictions by executing offensive and defensive mechanisms to protect their place in the mortgage industry, most notably their knack for tapping into the social value of American homeownership. The importance of this congressional inaction will come to light in the next two sections. I will contend that Fannie Mae and Freddie Mac were forced to serve “two irreconcilable masters,” which stipulated that they provide two sets of particular goods: one to their investors and the other to Congress and the American public. In a fascinating mixture of an over-zealous pursuit of profit and a congressional mandate to delve deeper into the subprime mortgage market, Fannie Mae and Freddie Mac took progressively greater risks. The two housing GSEs were part of a gambit that could only be pulled off as long as house prices continued to rise. Once those prices

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declined, both collapsed with great celerity and were placed into conservatorship in September of 2008.

In the final analysis, many parties contributed to the subprime mortgage crisis, and the ones that are covered most extensively in this study deserve to shoulder the bulk of the responsibility. Lonergan’s thoughts on the notion of collective responsibility are worth quoting in full:

The notion of collective responsibility is not without its difficulty. One may claim that, as men individually are responsible for the lives they lead, so collectively they must be responsible for the resultant situation. But that claim is too rapid to be convincing. No doubt, single elements in the resulting situation are identical with the actions or the effects for which individuals are responsible. But the resulting situation as a whole commonly was neither foreseen nor intended or, when it does happen that it was, still such foresight and intention are apt to reside not in the many but in the few and rather in secret schemes and machinations than in public avowal.  

Over the course of this study, one will discover startling instances of both ignorance and, if not secret at the time, at least under-publicized schemes and courses of action that were executed by parties who stood to greatly profit from them, at least in the short-term. The subprime mortgage crisis was not inevitable and this study will attempt to explain why.

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Chapter One

1.0. A Selection of Lonergan’s Theoretical Terms

1.1. Introduction

On January 13, 2010, the CEOs of Goldman Sachs, Morgan Stanley, JPMorgan Chase, and Bank of America testified before the Financial Crisis Inquiry Commission (FCIC), a body created by Congress to investigate the causes of the subprime mortgage crisis. At one point during the hearing, the chairman of the FCIC, Phil Angelides, pressed Goldman Sachs’ CEO, Lloyd Blankfein, to discuss the excessive nature of the risks that his firm took leading up to the subprime mortgage crisis. One of the more pointed questions that Angelides asked was whether Blankfein believed that Goldman Sachs, with its excessive risk profile, would have survived the crisis, bereft of the federal bailout that the firm received.

Blankfein’s response was memorable. Likening the financial crisis to a hurricane, Blankfein implied that the adverse conditions that Goldman Sachs encountered at the time were due to factors that were outside of the firm’s control. Implicitly, then, the firm was not responsible for its precarious position. After this response, Angelides stated, “Mr. Blankfein, I want to say this. Having sat on the board of the California Earthquake Authority, acts of God we’ll exempt. These were acts of men and women.”

The theoretical groundwork of my study of the subprime mortgage crisis will be laid out in this chapter. My thesis is that the crisis was the product of an accumulation of biased human judgments and decisions that, over time, resulted in a partial, though

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serious, breakdown in what Lonergan calls the good of order. This latter notion is part of his notion of the invariant structure of the human good. To understand this structure and the particular breakdown that will occupy much of this study, one needs to come to terms with Lonergan’s foundational, transcendental method (section 1.2). Building upon this method, I will explore Lonergan’s notions of self-appropriation (sections 1.3 and 1.4), common sense knowing (section 1.5), evaluating and deliberating (section 1.6), values, judgments of value, and feelings (section 1.7), religious and moral conversion (section 1.8), moral self-transcendence, deciding, and authenticity (section 1.9), and the three biases (section 1.10). Having discussed these theoretical tools, I will be in a position to examine Lonergan’s notion of the invariant structure of the human good (section 1.11) and, in later chapters, explain precisely how general and group bias inflicted damage on this structure. The subprime mortgage crisis was not an act of God or due to chance, but rather was the cumulative product of biased human judgments and decisions that were freely made by various distinct, related, and involved parties.

1.2. The Foundational Method and Cognitional Self-Transcendence

Lonergan’s transcendental method is “a normative pattern of recurrent and related operations yielding cumulative and progressive results.” 36 The method is transcendental in the sense that “it is not categorically determined to some particular field.” 37 While there are particular methods, such as the scientific method, which can be specially adapted to the needs and opportunities of particular fields, Lonergan’s method underpins

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all of those categorically-limited methods. Lonergan conceives of this method as “the assault on the citadel: it is the possession of the basic method, and all other methods are just so many extensions and adaptations of it.”

This method has as its first principles not universal premises or abstract logical propositions, “but concrete realities, namely, sensitively, intellectually, rationally, and morally conscious subjects.” As Lonergan declares, “[I]t is the de facto empirically existing subject that is the basis of everything I’m saying. And I’m asking each subject to be his own basis and to find in himself what his own basis is.” He discusses the transcendental method not to have a basis in some objective set of statements, but rather to help us be aware of ourselves. Lonergan puts the matter this way in his Understanding and Being:

What do you do not to have to depend on somebody’s definition, or somebody’s say-so, or ‘It is the way we always talk’? What do you base your ultimates on? What do you get from them? Is there any method of tackling that problem? And I think that’s the use I see in self-appropriation.

When one successfully arrives at what Lonergan calls “self-appropriation,” one will have something in oneself that will be one’s “ultimate court of appeal.” This court of appeal was sorely needed leading up to and during the outbreak of the subprime mortgage crisis. Lonergan urges “the necessity of self-appropriation of the subject, of coming to know at first hand oneself and one’s own operations... It is there that one will find the

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40 Ibid., 45-46.
41 Early Works on Theological Method I, 573.
42 Ibid., 439.
44 Ibid.
foundations of method.” Indeed, in *Method in Theology*, Lonergan states that self-appropriation is “a grasp of transcendental method.” In another work, Lonergan writes, “Insofar as there is the self-appropriation of the subject, insofar as he becomes clearly and distinctly aware of his operations, there arises method.”

Lonergan’s transcendental method, then, is not a set of verbal pronouncements enouncing rules to be followed, but is rather a matter of “how you do things.” For this reason, I believe, Lonergan places a pattern of operations in the foreground of his notion of method. The operations include “seeing, hearing, touching, smelling, tasting, inquiring, imagining, understanding, conceiving, formulating, reflecting, marshaling and weighing the evidence, judging, deliberating, evaluating, deciding, speaking, writing.”

Lonergan assumes that everyone is familiar with at least some of the operations and has a notion of what the other terms mean. These operations form a pattern, whose proper understanding Lonergan calls “an explanatory apprehension” of the operations. When one knows the operations in their interrelations, one has grasped the operations’ pattern.

The basic terms in Lonergan’s method are the operations, while the basic relations are the interrelations between those operations. Similar to contemporary mathematicians, Lonergan notes that he is attempting to “set up a basic vicious circle in which the terms are clarified by their relations to one another and the relations are

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46 *Method in Theology*, 83.
47 *Early Works on Theological Method I*, 138.
49 *Early Works on Theological Method I*, 427. Italics his.
50 Ibid.
51 *Method in Theology*, 7.
52 *Early Works on Theological Method I*, 427.
53 Ibid.
54 Ibid.
clarified by the terms that they relate.”55 These basic terms “denote the conscious and intentional operations that occur in human knowing,”56 which raises the question of what Lonergan means by “conscious” and “intentional.”

Lonergan’s appraisal of human consciousness is quite complex.57 According to him, consciousness is “interior experience of oneself and one’s acts, where ‘experience’ is taken in the strict sense of the word.”58 Experience in “the strict sense” is a “preliminary unstructured sort of awareness that is presupposed by intellectual inquiry and completed by it.”59 This awareness is preliminary in the sense that it is a condition for the possibility all intellectual inquiry.60 Lonergan maintains that this awareness is unstructured because “if it were already intelligibly formed, further inquiry would be superfluous.”61

Experience in this strict sense can be either exterior or interior. With exterior experience “we see colors, hear sounds, taste flavors, smell odors, and feel things hard or soft, hot or cold, heavy or light, smooth or rough.”62 These exterior experiences precede

55 Ibid.
59 Ibid.
60 Ibid., 159.
61 Ibid.
62 Ibid.
any inquiries, formulations of concepts, or judgments, which is why they qualify as experiences in the strict sense of the word.\textsuperscript{63}

Consciousness, though, is interior experience of oneself and one’s acts. Lonergan explicitly contends that a human being is not conscious “through some distinct and special operation by which one intuits oneself on the side of the object,” for no such operation exists.\textsuperscript{64} Instead, human consciousness is “a certain presence of oneself to oneself.”\textsuperscript{65}

To help clarify the sort of presence that Lonergan has in mind here, one can turn to his \textit{Understanding and Being}, where he notes that the term is ambiguous and proceeds to distinguish three types of presence.\textsuperscript{66} First, there is a material presence in which inanimate objects are present in some space, such as a room. Lonergan notes, for instance, that “you could say that the chairs are present in the room, but you cannot say that the chairs are present to the room or that the room is present to the chairs.”\textsuperscript{67} This latter, second type of presence, of being present \textit{to} someone, applies to both human beings and animals. Of greater interest to Lonergan is the third, fundamental type of presence, one in which one is present not to someone else, but to oneself. Someone or something else being present to me presupposes that I am somehow present to myself.\textsuperscript{68}

Lonergan underscores the elusiveness of this primordial presence, playfully noting that it cannot be attained by craning one’s neck around and looking into oneself to

\textsuperscript{64} \textit{The Ontological and Psychological Constitution of Christ}, 183.
\textsuperscript{65} Ibid., 187.
\textsuperscript{66} \textit{Understanding and Being}, 15.
\textsuperscript{67} Ibid.
\textsuperscript{68} Ibid.
see if one is there. To be conscious of oneself, one would not look at oneself as though one were an object. Human consciousness is not awareness “on the side of the object that is observed, but on the side of the subject that observes.” As Joseph Flanagan writes, “Consciousness is not something that you can hold up for examination, rather it is known indirectly through certain conscious acts you perform and through you, the subject, consciously acting.” In other words, human beings are only conscious of themselves by way of their acts or operations, which is precisely what Lonergan’s terse definition of consciousness suggests. Salvino Biolo argues that Lonergan’s account of human consciousness is original, for he was able to define the indefinable, conceptualize the pre-conceptual.

While all of the operations listed above are conscious, they are also intentional. An operation is intentional in the sense that, by way of the performance of the operation, objects become present to the subject. Consider the intentionality accompanying the operation of seeing, for example. Lonergan states, “The objects become present to me... If I close my eyes, the operation of seeing does not occur. I open them, and I do see colors and shapes before my eyes.” The “psychological sense” in which the operations

69 Ibid.
70 Understanding and Being, 20-21.
71 The Ontological and Psychological Constitution of Christ, 183.
72 Joseph Flanagan, Quest for Self-Knowledge (Toronto: University of Toronto, 1997), 132.
73 The Ontological and Psychological Constitution of Christ, 167.
75 Method in Theology, 9.
76 Early Works on Theological Method I, 428.
77 Ibid.
have objects is what Lonergan means by the term “intentional”: it is “my awareness of objects and the object’s presence to me.”

In sum, all of the operations listed above, as conscious and intentional, have a twofold psychological dimension. As intentional, when one performs any of the operations, objects become present to the subject. As conscious, when one performs any of the operations the subject and the operations become present to the subject.

While there are different kinds of presence, there are also different kinds of intentionality and different kinds of consciousness. In an effort to discuss these differences in intentionality and consciousness, Lonergan notices four interrelated levels of conscious intentionality: the empirical, the intellectual, the rational, and the responsible. For now, I will focus only on the first three of those levels.

What distinguishes the levels of conscious intentionality from one another is the quality of self-presence of the subject to himself or herself when performing the operations on each level. The performance of different operations yields “qualitatively different modes of being conscious subjects… and qualitatively different modes of intending.” Before examining the qualitatively different modes of consciousness and intentionality on each level, it will be helpful to highlight a distinction that Lonergan makes between two types of movements: a vertical movement and a horizontal movement. What accounts for this distinction is the type of data that are serving as the point of departure for the subject’s operations. One should note that Lonergan’s method

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78 Ibid.
79 Ibid.
80 Ibid.
81 Ibid., 430.
82 The Ontological and Psychological Constitution of Christ, 165.
83 Method in Theology, 10.
84 Early Works on Theological Method I, 430.
embraces both kinds of data, but places in a privileged position the data of consciousness. The vertical movement describes the process of cognitional self-transcendence, whereas the horizontal movement describes the critical process of self-appropriation.

The vertical movement starts with the given data of sense, which one experiences sensitively. The data of sense includes “colors, shapes, sounds, odors, tastes, the hard and soft, rough and smooth, hot and cold, wet and dry.” From these sensitive experiences, one can move up through the other levels of consciousness, inquiring, getting insights, reflecting, and judging, to making statements about sensible things. Importantly, the driving force behind the vertical movement, beyond the initial, modest movement from a dreaming to a waking state, is inquiry: the posing of certain types of questions to oneself.

The horizontal movement, on the other hand, involves the data of consciousness, which is consciousness of the human operations identified above. The data of consciousness is made possible by the performance of the operations that are present in a vertical movement. To help clarify this point, Lonergan states:

The operations become conscious [in a horizontal movement] insofar as you start from the data of sense, inquire, understand, formulate, reflect, weigh the evidence, judge, deliberate, evaluate, decide. In the occurrence of the operations is to be found consciousness of the operations... Insofar as this consciousness has been elicited, there are available the data of consciousness to which you can again apply the operations, this time as intentional, to the operations as conscious. You can inquire about the data of consciousness and come to understand them and formulate what you have understood, reflect on your formulations,
weigh the evidence for the accuracy of your formulations, make your judgments, and decide on your methods.\textsuperscript{90}

Similar to the movement that is possible vertically, one is capable of moving horizontally from “the data of consciousness through inquiry, understanding, reflection, judgment, to statements about conscious subjects and their operations.”\textsuperscript{91} Lonergan characterizes the process that is contained in this movement as one of objectification, which is “a matter of applying the operations as intentional to the operations as conscious.”\textsuperscript{92} This is the crucial process of self-appropriation,\textsuperscript{93} the foundation of Lonergan’s method.\textsuperscript{94} This horizontal movement, then, is of special interest.

With the distinction between these two movements in mind, one can now turn to the three initial levels of conscious intentionality and better understand how there are qualitatively different modes of consciousness and intentionality on each level. Empirical consciousness, the first level, is characteristic of sensing, perceiving, imagining.\textsuperscript{95} In \textit{Method in Theology}, Lonergan adds the operations of feeling, speaking, and moving to this level.\textsuperscript{96} When one is \textit{only} empirically conscious, one is sensing things, but not worried about any meaning in them.\textsuperscript{97} One will have “empirical presentations without inquiry.”\textsuperscript{98} Lonergan gives the example of an empirically conscious subject as one who is lying on the beach on a warm day watching the clouds pass by without any concern for

\textsuperscript{90} \textit{Early Works on Theological Method I}, 437.
\textsuperscript{91} \textit{Method in Theology}, 9.
\textsuperscript{92} \textit{Early Works on Theological Method I}, 437.
\textsuperscript{93} Ibid., 436. Here, Lonergan writes, “[Self-Appropriation] is a process of objectifying oneself from the evidence supplied by oneself.”
\textsuperscript{95} \textit{Insight}, 346.
\textsuperscript{96} Ibid., \textit{Method in Theology} (New York: Herder and Herder, 1973), 9.
\textsuperscript{98} \textit{Understanding and Being}, 36.
anything whatsoever. Confined to this level, the subject is experiencing empirical presentations, but is not exerting any effort to understand them. The mode of intending at this level, made possible by the vertical movement from the dream state to the waking state, is a matter of attending to the data of sense. With respect to the horizontal movement, the mode of intending at this level consists of “heightening one’s consciousness of one’s experiencing, understanding, judging.”

On the intellectual level of consciousness, one is inquiring, seeking understanding, having insights, expressing what one has understood, working out the presuppositions and implications of that expression, and raising further questions for intelligence. When one is intellectually conscious, one is engaging in “intellectual inquiry and in acts of understanding and defining, operating as an intelligent person.” Intelligence is operating in all of the above acts. The next step in the vertical movement is made possible by inquiry, the posing of questions for intelligence such as “what and why, what for and how.” The mode of intending on this second level, which is made possible by this next step in the vertical movement, is an active apprehending, not of the given data of sense, but of “a unity or relationship that is possibly relevant to the data.” In terms of the mode of intending that is present on this level in a horizontal movement,
the object to be understood is “one’s experienced experiencing, understanding, judging, deciding.”

The rational level of consciousness is characterized by activities such as reflecting, marshaling and weighing the evidence, grasping sufficient grounds for judging, and passing judgment on the truth or falsity, certainty or probability, of a statement. On this level, one is critically inquiring whether something exists and is so. One is rationally conscious insofar as one “puts questions for reflection, grasps the unconditioned, and passes judgment.” One moves vertically, up from the second level of consciousness to the third, by way of posing a question for reflection to oneself: “Is it so?” The mode of intending that is present on this third level of consciousness is something that is independent of oneself: a judgment about whether something is so. With respect to the horizontal movement on this level, the object to be affirmed is the “understood relations of experienced experiencing, understanding, judging, and affirming.”

At each of these levels of conscious intentionality, the subject is conscious in a qualitatively distinct way. Furthermore, the intentionality of the subject’s operations at each level is qualitatively distinct. Despite these differences among the levels, they are also related to one another. Lonergan argues that the relations among the levels can be expressed as instances of sublation, by which he means the lower levels are “retained,

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108 Ibid., 437.
109 Ibid., 9.
110 The Ontological and Psychological Constitution of Christ, 169.
111 Insight, 726.
112 Early Works on Theological Method I, 432.
113 Ibid., 438.
preserved, yet transcended and completed by a higher.”

As Lonergan states, “Experiencing is presupposed and complemented by inquiry and understanding. Experiencing and understanding are presupposed and complemented by reflecting and judging.” Each of the later levels goes beyond the preceding ones, “introduces something entirely new, [and] makes that element a new basis of operation.” Far from sabotaging or interfering with the preceding levels, the later levels preserve, perfect, and extend their relevance and significance. Without the preceding levels, though, the later levels would not have anything to complete.

One may wonder what propels the subject from the lower levels to the higher ones. Lonergan argues that the source of this movement lies in the dynamism of our conscious intentionality, what he calls the transcendental notions: the intelligible, the true, and the good. These notions are transcendental because they transcend any specific content. When one asks a question for intelligence, such as “What is it?,” one is intending the intelligible. On the third level of consciousness, one can ask the question, “Is that so?,” which intends the truth of one’s understanding and the reality of what one takes to be a fact. The transcendental notions are what one ultimately intends

116 Ibid., 319.
117 Ibid.
118 Insight, 300.
119 Method in Theology, 34
120 Ibid., 11.
122 Early Works on Theological Method I, 433.
123 Ibid.
when one asks a question\textsuperscript{124} and they apply to every single object “for the very good reason that they are grounded in the successive stages in our dealing with objects.”\textsuperscript{125}

The transcendental notions “constitute our capacity for self-transcendence.”\textsuperscript{126} They are subunits or stages of the unfolding of the pure, disinterested, detached, and unrestricted desire to know. The pure desire to know is “something substantial and common to human nature and human activity.”\textsuperscript{127} It is “the eros of the human spirit,”\textsuperscript{128} a subject’s imperiously inquiring and critical spirit.\textsuperscript{129}

The pure desire to know is a subject’s basic orientation. It is a fundamental, total openness to all questioning.\textsuperscript{130} As unrestricted, the pure desire “inquires into everything, and asks everything about everything.”\textsuperscript{131} It demands “the intelligent and critical handling of every question,”\textsuperscript{132} which is the source of the recurrent nature of the subject’s operations that take place at the second and third levels of conscious intentionality. It is worth reiterating that the operations contained in Lonergan’s definition of method are not only related, but also recurrent. Our conscious and intentional operations are characterized by an “ever going beyond what happens to be given or known, ever striving for a fuller and richer apprehension of the yet unknown or incompletely known totality, \textsuperscript{132}

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\textsuperscript{124} Bernard Lonergan, “What Are Judgments of Value?,” 142.
\textsuperscript{126} \textit{Method in Theology}, 105.
\textsuperscript{127} Ibid., 302.
\textsuperscript{128} Ibid., 13.
\textsuperscript{129} \textit{Insight}, 372.
\textsuperscript{131} Ibid.
\textsuperscript{132} \textit{Insight}, 660-661.
whole, universe.” This “ever going beyond” requires the subject to perpetually perform the operations at the second and third level of consciousness.

Lonergan notes that this desire is also the subject’s immanent source of transcendence. By “transcendence,” Lonergan means that human development is a matter of the subject’s transcending or going beyond himself. As Lonergan states, “All development is development inasmuch as it goes beyond the initial subject, but in man this ‘going beyond’ is anticipated immanently by the detachment and disinterestedness of the pure desire.” The operator of our cognitional development is precisely this pure desire to know.

As soon as one wakes up and starts the day, one begins to be pushed or pulled beyond oneself. Lonergan writes, “Already on the level of experience we are going beyond ourselves in apprehending and in responding to persons and things about us.” As modest as this self-transcendence may be, one is still moving out of oneself.

Not content with the level of experience, with the inescapable and spontaneous flow of sensible presentations, images, feelings, conations, and movements, one spontaneously succumbs “to the wonder that Aristotle named the beginning of all of science and philosophy.” This wonder can be formulated by asking questions for

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133 Method in Theology, 13.
134 Insight, 659.
136 Insight, 499.
137 Ibid., 659.
140 Early Works on Theological Method I, 432.
142 Insight, 354.
intelligence, such as why, what for, or how. Inquiring is an active principle that intends more than the “cinematographic flow of presentations and presentations,” its intention is an answer, an insight. The process triggered by wonder and the subsequent inquiry prompts the subject, then, to go beyond the sensibly given and methodically seek, accumulate, and classify possibly relevant data that may, with a little luck, give rise to the desired insight or insights. Once the relevant insight is reached, the pure desire is transformed into one that aims “to formulate, to express in concepts and in words,” what the insight has grasped. The transcendence accomplished at this point comes in the form of the subject moving out into a world through his intelligence. The world Lonergan seems to have in mind is one that is constructed by the subject, a whole hypothetical world in which the sensibly given data find their place and their relationships with one another.

However intellectually satisfying the grasping and subsequent formulating of a direct insight may be, the pure desire is not assuaged. There is still a more radical, decisive stage in the process of cognitional self-transcendence, one that goes beyond “the more elementary concerns of both sense and intelligence.” One has moved past “imagination and guesswork, idea and hypothesis, theory and system, to ask about reality.” Greeting the formulated insight is the pure desire’s demand for sufficient evidence. This demand is encapsulated in the question for reflection: “It is so?”

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143 Bernard Lonergan, “Natural Right and Historical Mindedness,” 172.
144 Insight, 355.
145 Bernard Lonergan, “Theories of Inquiry,” 34.
146 Ibid., 33; Lonergan, “Natural Right and Historical Mindedness,” 172.
147 Ibid., “Theories of Inquiry,” 34.
148 Early Works on Theological Method I, 482.
149 Bernard Lonergan, “What are Judgments of Value?,” 143.
150 Ibid., “Natural Right and Historical Mindedness,” 172.
151 Ibid.
152 Early Works on Theological Method I, 482.
one grasp the sufficiency of the evidence, grasp the virtually unconditioned, and judge that something is or is not so, the subject has transcended himself and arrived at what would be so even if he did not exist.\textsuperscript{153} This is the apex of cognitional self-transcendence, when the subject has moved to what is independent of himself.\textsuperscript{154}

This, in brief, is an outline of Lonergan’s cognitional structure, which I will examine in slightly greater detail below. For now, the point that I would like to emphasize is that the pure desire to know and its unfolding “impose a normative structure upon man’s cognitional acts” and enable one to transcend oneself.\textsuperscript{155} On the level of experience, one cannot escape sensations, percepts, and images.\textsuperscript{156} Lonergan notes that one “cannot be one of the Seven Holy Sleepers,” sleeping all of the time.\textsuperscript{157} Experiencing is inevitable, it cannot be avoided.

On the intellectual level of consciousness, the normativity can be discerned through the way in which “the intelligence in each of us prompts us to seek understanding, to be dissatisfied with a mere glimmer, to keep probing for an ever fuller grasp, to pin down in accurate expression just what we so far have attained.”\textsuperscript{158} The relentless quest of the pure desire to know for intelligibility is made manifest by the questions that one asks about one’s experiences. In \textit{Insight}, Lonergan underscores how being unintelligent is not a practical choice.\textsuperscript{159} He writes:

\begin{quote}
I can deprecate intelligence; I can ridicule its aspirations; I can reduce its use to a minimum; but it does not follow that I can eliminate it. I can
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\begin{thebibliography}{9}
\bibitem{153} Bernard Lonergan, “Natural Knowledge of God,” 128.
\bibitem{154} \textit{Early Works on Theological Method I}, 482.
\bibitem{155} \textit{Insight}, 420.
\bibitem{156} Ibid., 354.
\bibitem{158} Ibid., “Religious Knowledge,” 143.
\bibitem{159} \textit{Insight}, 354.
\end{thebibliography}
question everything else, but to question questioning is self-destructive. I might call upon intelligence for the conception of a plan to escape intelligence, but the effort to escape would only reveal my present involvement, and strangely enough, I would want to go about the business intelligently, and I would want to claim that escaping was the intelligent thing to do.160

One cannot avoid the fact that one has intelligence and questions for understanding continually emerge.161

Likewise, on the third level of consciousness, “one quickly encounters the inevitability of reflection and judgment.”162 Insights are a dime a dozen, “so critical reasonableness doubts, checks, makes sure.”163 There is a “self-assertive spontaneity that demands sufficient reason for all else but offers no justification for its demanding.”164 This spontaneity “arises, fact-like, to generate knowledge of fact, to push the cognitional process from the conditioned structures of intelligence to unreserved affirmation of the unconditioned.”165 Moreover, not only does this spontaneity occur, it will recur whenever the conditions for reflection are fulfilled.166 The work performed by the subject on the second level of consciousness is not done for its own sake, but rather for the sake of an ulterior motive: judging.167

The key point here is that there are immanent criteria in one’s operations at each level of consciousness and these criteria beckon the subject to go beyond himself.168 Lonergan observes, “[I]nsofar as you invite subjects to try and put off their intelligence,

160 Ibid.
161 Bernard Lonergan, “Philosophical Positions with Regard to Knowing,” 224.
162 Ibid.
163 Method in Theology, 13.
164 Insight, 356.
165 Ibid.
166 Ibid.
167 Ibid., 298.
to try and put off their reasonableness, that they will find in the subject as subject that they cannot do so.\textsuperscript{169} He forcefully characterizes this immanent normativity this way:

Spontaneously, we move from experiencing to the effort to understand; and the spontaneity is not unconscious or blind; on the contrary, it is constitutive of our conscious intelligence, just as the absence of the effort to understand is constitutive of stupidity. Spontaneously we move from understanding with its manifold and conflicting expressions to critical reflection; again the spontaneity is not unconscious or blind; it is constitutive of our critical rationality, of the demand within us for sufficient reason; and it is the neglect or absence of this demand that constitutes silliness.\textsuperscript{170}

There is, then, a normativity that one cannot dodge without amputating one’s reasonableness, intelligence, and sensitivity.\textsuperscript{171} This normativity is especially made manifest by the types of questions that spontaneously emerge at each level. Spontaneously, questions for intelligence and reflection emerge and place demands upon the subject. The questions delimit both what the answers will have to be about and which operations are going to have to be employed in order to answer them.\textsuperscript{172} One’s questions serve as signposts, directing one about how to go about transcending oneself.

In light of this immanent normativity, three unexpressed\textsuperscript{173} transcendental precepts can be appropriated as binding on oneself: Be attentive, Be intelligent, Be reasonable.\textsuperscript{174} These transcendental precepts “have a prior existence and reality in the spontaneous, structured dynamism of human consciousness.”\textsuperscript{175} They are permanent\textsuperscript{176} and their reality becomes apparent simply through a study of the operations


\textsuperscript{170} \textit{Method in Theology}, 18.

\textsuperscript{171} Ibid.

\textsuperscript{172} Bernard Lonergan, “Cognitional Structure,” 212.

\textsuperscript{173} \textit{Method in Theology}, 302.

\textsuperscript{174} \textit{Early Works on Theological Method I}, 442.

\textsuperscript{175} \textit{Method in Theology}, 20.

\textsuperscript{176} Ibid., 53.
themselves. Following the bidding of the pure desire to know, that “built-in law of the human spirit,” one cannot help but make decisions to either cooperate or fail to cooperate with one’s own normative structure. Since one must use this very structure in order to decide whether to cooperate with it, this implies precepts or imperatives that one ought to do so.

Up until this point, I have been attempting to provide a first approximation of what Lonergan means by “a normative pattern” and “recurrent and related operations” in his definition of method. My focus so far has been exclusively on the subject’s cognitional operations. Since these operations are both conscious and intentional, I examined what Lonergan means by both of those terms. I also attempted to explain, within the confines of the subject’s cognitional operations, what Lonergan means by a normative pattern. Hopefully, this discussion cast light on how these operations are continually recur and are related to one another.

Presently, I would like to examine Lonergan’s cognitional theory more explicitly, which is a theory “about what goes on when we know.” According to this theory, human knowing is a structure. This structure applies to both the data of sense and the data of consciousness. I will examine both of them, in turn.

Human knowing, according to Lonergan, is a materially and formally dynamic structure. It is a structure in the sense that it is a whole whose parts are functionally related to one another. Each part of this structure “is just what it is because of its

177 Ibid.
178 Understanding and Being, 134.
180 Ibid., “Philosophical Positions with Regard to Knowing,” 216.
functional relations to the other parts.”

Importantly, the parts also determine what the whole has to be.

Human knowing is a materially dynamic structure because its parts are not made of material things, like an automobile, but instead are operations. While being functionally related to each other, these operations are dissimilar and distinct from one another and include “seeing, hearing, touching, smelling, tasting, inquiring, imagining, understanding, conceiving, formulating, reflecting, marshaling and weighing the evidence, judging, deliberating, evaluating, deciding, speaking, writing.” As a formally dynamic structure, human knowing is self-assembling or self-constituting. As Lonergan explains, “It puts itself together, one part summoning forth the next, till the whole is reached.” This self-assembling occurs consciously, intelligently, and rationally, as opposed to unconsciously or blindly.

With respect to the vertical movement, which begins with the given data of sense, our operations of seeing, hearing, touching, tasting, and smelling occur on what Lonergan calls the level of presentations. One’s empirical presentations are the materials that are presupposed by the posing of questions for explanation or intelligence such as “What?,” “Why?,” and “How often?” In response to these questions, there are “insights and thoughts, concepts, formulations, hypotheses, theories.”

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181 Ibid.
182 Ibid.
183 Ibid.
184 Ibid. Early Works on Theological Method I, 427.
186 Ibid.
187 Ibid.
188 Ibid. Insight, 298-299.
189 Ibid. Insight, 298.
190 Bernard Lonergan, “Philosophical Positions with Regard to Knowing,” 216.
Every tentative answer to a question for intelligence, however, merely raises further questions for reflection: “Is it?” or “Is it so?”\textsuperscript{191} Answers to questions for reflection demand judgments of yes or no, although they can be qualified in an indefinite number of ways, such as “‘certainly,’ ‘probably,’ and ‘possibly’.”\textsuperscript{192} What are the grounds for one’s prospective judgment, for judging that the content of an insight generated at the level of intelligence is so?

The initial answer that Lonergan provides to this question in Chapter 10 of \textit{Insight} is that one has grasped the sufficiency of the evidence for a prospective judgment by an act of reflective understanding.\textsuperscript{193} When one has grasped the sufficiency of evidence for a prospective judgment, one has grasped the prospective judgment as virtually unconditioned.\textsuperscript{194} The virtually unconditioned involves three elements: a conditioned, a link between the conditioned and its conditions, and the fulfillment of the conditions.\textsuperscript{195} As Lonergan explains, “The function of reflective understanding is to meet the question for reflection by transforming the prospective judgment from the status of a conditioned to the status of a virtually unconditioned; and reflective understanding effects this transformation by grasping the conditions of the conditioned and their fulfillment.”\textsuperscript{196} This process can be illuminated by examining the three elements of the virtually unconditioned.

The conditioned is the prospective judgment in virtue of the fact that “it stands in need of evidence sufficient for reasonable pronouncement.”\textsuperscript{197} The link between the

\textsuperscript{191} \textit{Insight}, 298.
\textsuperscript{192} \textit{Understanding and Being}, 124.
\textsuperscript{193} \textit{Insight}, 304.
\textsuperscript{194} Ibid., 305.
\textsuperscript{195} Ibid.
\textsuperscript{196} Ibid.
\textsuperscript{197} Ibid.
conditioned and its conditions is “a law immanent and operative in cognitional process,” which is “simply a way of doing things, a procedure within the cognitional field.” To get a handle on this law, Lonergan examines the difference between vulnerable and invulnerable insights. When an insight is vulnerable, further pertinent questions may be raised on the same issue, which reveal the “unsatisfactoriness of the insight” and evoke “the further insights that put a new light on the matter.” Invulnerable insights, conversely, meet the issue squarely and are not, therefore, subject to further pertinent questions. In the absence of any further questions, there cannot be any “further insights to challenge the initial position.”

Lonergan argues that the distinction between vulnerable and invulnerable insights is an operational distinction, one that precedes the conceptual distinction between correct and mistaken insights. Lonergan declares, “Insights are correct as a matter of fact, and the fact is that there are no further relevant questions.” If, in fact, there are no further pertinent questions, “then in fact the insight is invulnerable; if in fact the insight is invulnerable, then in fact the judgment approving it will be correct.” Insights that are susceptible to further pertinent questions should indicate to the subject that the requisite conditions have not been fulfilled for affirming or denying a prospective judgment. In other words, under such conditions, one has not grasped the virtually conditioned and one’s judgment should be a reflection of that fact, perhaps by proceeding to make one that affirms that the conditioned cannot yet be affirmed or denied.

198 Ibid., 309.
199 Ibid., 307.
200 Ibid., 309.
201 Ibid.
202 Ibid.
203 Understanding and Being, 124. Italics his.
204 Insight, 310.
Building upon this point, Lonergan stresses that it is not enough that “no further relevant questions occur to me, but that there are no further relevant questions.”\footnote{Understanding and Being, 124. Italics his.} He explains:

The mere absence of further questions in my mind can have other causes. My intellectual curiosity may be stifled by other interests. My eagerness to satisfy other drives may refuse the further questions a chance to emerge. To pass judgment in that case is to be rash, to leap before one looks.\footnote{Insight, 309.}

In addition to rashness, another potential pitfall for judgers is that they can be indecisive due to a dissatisfaction with “the mere absence of further [pertinent] questions.”\footnote{Ibid.} One could also fail to have “good enough judgment to judge whether [the further relevant questions] are relevant or not.”\footnote{Understanding and Being, 124.}

As Patrick Byrne observes, the biases, which I will examine in a separate section, can also “block one’s awareness of further pertinent questions, which, if entertained and answered, would indeed lead to a partial or total correction of the insight under consideration.”\footnote{Patrick H. Byrne, “Analogical Knowledge of God and the Value of Moral Endeavor,” Method: Journal of Lonergan Studies, Vol. 11, No. 2, Ed. Patrick H. Byrne, Charles C. Hefling, and Mark D. Morelli (Chestnut Hill: The Lonergan Institute, 1993), 114, note 32. Hereafter, this article will be cited as “Analogical Knowledge...”.}

One may wonder how to become a good judge when there are so many ways to go astray. Fortunately, Lonergan provides a brief guide to developing good judgment. First, one needs to allow the seed of the pure desire to know “to grow into a rugged tree to hold its own against the desires and fears, conations and appetites, drives and interests” that inhabit one’s heart.\footnote{Insight, 310.} Second, Lonergan suggests that a significant amount of experience and time is needed to become a good judge. He argues that a “good judgment about any
Insight has to rest on the previous acquisition of a large number of other, connected, and correct insights.\textsuperscript{211} One needs to learn from past mistakes and allow the spontaneous self-correcting process of learning to take place.\textsuperscript{212} This process of learning “is a circuit in which insights reveal their shortcomings by putting forth deeds or words or thoughts, and through that revelation prompt the further questions that lead to complementary insights.”\textsuperscript{213} When one permits the self-correcting process of learning to occur, one will become progressively familiar with concrete situations and know what to expect in the midst of them.\textsuperscript{214} In the event that something unexpected occurs, the fruits of the self-correcting process of learning will create conditions for one to identify “what happened and why, and what can be done to favor or to prevent such a recurrence.”\textsuperscript{215}

In an important sense, the self-correcting process of learning is part of what enables Lonergan’s method to yield “cumulative and progressive results.” By “progressive results,” Lonergan means that “the operations include new discoveries,” and by “cumulative results,” he means that “the new discoveries have to be integrated with previous discoveries, the new insights added on to all previous insights.”\textsuperscript{216} When one has an insight, “one has only to act, or to talk, or perhaps merely to think, on the basis of that insight, for its incompleteness to come to light and thereby generate a further question.”\textsuperscript{217} One’s openness and receptivity to the cascade of further questions that emerge in response to one’s insights put one in a position to have “an accumulation of insights in which each successive act complements the accuracy and covers the

\begin{flushleft}
\textsuperscript{211} Ibid.
\textsuperscript{212} Ibid.
\textsuperscript{213} Ibid., 197.
\textsuperscript{214} Ibid., 311.
\textsuperscript{215} Ibid., 311-312.
\textsuperscript{216} Early Works on Theological Method I, 425.
\textsuperscript{217} Insight, 197.
\end{flushleft}
deficiency of those that went before.”

It would be difficult to have new insights, let alone to be in a position to integrate those insights with previous ones in a meaningful way, without actively and routinely engaging in the self-correcting process of learning. Certainly a failure to do so would hinder oneself from becoming a person of good judgment.219

1.3. Self-Appropriation and Its Importance

In addition to the vertical movement in the cognitional process described above, there is also the crucial horizontal movement, which is a reduplication or mirroring of that process.220 The key difference is that, in the horizontal movement, the relevant data are the data of consciousness instead of the data of sense.221 Lonergan invites us inquire into our own data of consciousness and “come to understand them and formulate what you have understood, reflect on your formulations, weigh the evidence for the accuracy of your formulations, make your judgments.”222

On the level of experience, one “has to experience one’s experiencing, understanding, judging.”223 Lonergan notes that this experience is a matter of “heightening one’s consciousness of one’s experiencing, understanding, judging.”224 Next, in coming to understand one’s experienced experiencing, understanding, and judging, one understands that “the operations are experienced not in isolation but in their

218 Ibid.
219 Ibid., 310-311.
221 Early Works on Theological Method I, 430.
222 Ibid., 437.
223 Ibid.
224 Ibid.
concomitance."\textsuperscript{225} There is a flow, within consciousness, from experience to inquiry, leading up to insight, which is the act of understanding that makes one able to intelligently operate in a given situation.\textsuperscript{226} One further understands that within consciousness “there is a critical demand for evidence, the refusal to assent with insufficient evidence, and the necessity of assenting because the evidence really is sufficient.”\textsuperscript{227}

Ultimately, what one understands is that there is a unity of consciousness itself\textsuperscript{228} and that this unity is given.\textsuperscript{229} By the very nature of the relatedness of the operations, there “must be one and the same [subject] that is inquiring and is perceiving,” for otherwise one’s inquiring would not be about one’s empirical presentations.\textsuperscript{230} Similarly, for an insight to be into one’s sensible presentations and elicited by one’s inquiry, “it must be one and the same that has the perceptions and has the insights.”\textsuperscript{231} In order for one’s conceiving to be able to “pick out what is essential to the insight in the presentations, it must be one and the same that is conceiving and understanding and perceiving.”\textsuperscript{232} Finally, in order for “a judgment to proceed rationally from the grasp of the unconditioned, it must be one and the same that grasps the unconditioned and judges.”\textsuperscript{233}

\textsuperscript{225} Ibid.
\textsuperscript{226} Ibid., 437-438.
\textsuperscript{227} Ibid., 438.
\textsuperscript{228} Ibid.
\textsuperscript{229} \textit{Insight}, 350-352.
\textsuperscript{230} \textit{Understanding and Being}, 137.
\textsuperscript{231} Ibid., 138.
\textsuperscript{232} Ibid.
\textsuperscript{233} Ibid.
The last step in this horizontal movement, in this process of self-appropriation, is that one has to affirm whether one’s conscious operations actually occur.\textsuperscript{234} Or, as Lonergan puts it, one needs to affirm “the understood relations of experienced experiencing, understanding, judging.”\textsuperscript{235} The conditioned, prospective judgment is “I am a knower.”\textsuperscript{236} The link between the conditioned and its conditions is contained in the proposition: “I am a knower if I am a unity performing certain kinds of acts.”\textsuperscript{237} The fulfillment of the conditions is found in the data of consciousness.\textsuperscript{238} Lonergan poses a number of questions in \textit{Insight} to help one grasp the sufficiency of the evidence that one is a knower:

Do I see, or am I blind? Do I hear, or am I deaf? Do I try to understand, or is the distinction between intelligence and stupidity no more applicable to me than to a stone? Have I any experience of insight, or is the story of Archimedes as strange to me as the account of Plotinus’s vision of the One? Do I conceive, think, consider, suppose, define, formulate, or is my talking like the talking of a parrot? I reflect, for I ask whether I am a knower. Do I grasp the unconditioned, if not in other instances, then in this one? If I grasped the unconditioned, would I not be under the rational compulsion of affirming that I am a knower, and so either affirm it or else find some loophole, some weakness, some incoherence, in this account of the genesis of self-affirmation?\textsuperscript{239}

Only a “non-reasonable, non-intelligent somnambulist” would declare that these conscious and intentional operations do not exist.\textsuperscript{240} If one wanted to deny that one is a knower, one would have to use one’s own knowing in the very process of attempting to deny the fact that one is a knower.\textsuperscript{241}

\textsuperscript{234} \textit{Early Works on Theological Method} I, 438.
\textsuperscript{235} Ibid.
\textsuperscript{236} \textit{Insight}, 352.
\textsuperscript{237} Ibid.
\textsuperscript{238} Ibid.
\textsuperscript{239} \textit{Insight}, 352-353.
\textsuperscript{240} \textit{Early Works on Theological Method} I, 438.
\textsuperscript{241} Joseph Flanagan, \textit{Quest for Self-Knowledge}, 134.
Not only must the operations be affirmed as existing, one must also affirm that they exist in the normative pattern described above, the one that is constituted by one’s own intelligence and reasonableness.\footnote{Early Works on Theological Method I, 439.} The basis for this affirmation stems from the fact that any dramatic revision of this pattern would consist of “putting out a new edition of man as something radically different from what we have known him to be.”\footnote{Ibid.} Yet, such revisions would have to be limited, for one would have to appeal to data and, therefore, presuppose an empirical level of operations.\footnote{Method in Theology, 19.} One’s revisions would also have to serve as a better explanation of the data, which would presuppose an intellectual level of operations.\footnote{Ibid.} Finally, one’s revisions, which hypothetically and tentatively explain the data in a better fashion, would have to be judged as being, in fact, or at least probably, superior to the pattern that one affirmed as operative in oneself.\footnote{Ibid.} Thus, if one affirmed the superiority of one’s revisions, one would be presupposing a rational level of operations.\footnote{Ibid.}

Lonergan admits that the pattern could potentially be improved upon, for new things could be learned, further complexities could be discovered, and a fuller and more adequate account could be provided.\footnote{Early Works on Theological Method I, 439.} Any possibility of a revision, however, would have to include the pattern of operations that are at the core of the transcendental method.\footnote{Ibid.} As Lonergan states, “[The] invariance of the pattern that grounds the possibility of a revision also limits the possibility of revision.”\footnote{Ibid.} In this sense,
Lonergan’s method can serve as “a rock on which one can build.” Every other known becomes known through this process, since “no known could impugn the process without simultaneously impugning its own status as a known.”

In this section, for the sake of clarity, I have underscored a variety of cognitional operations that are part of Lonergan’s transcendental method, the ones that are confined to the first three levels of conscious intentionality: the empirical, the intellectual, and the rational. Over the course of this discussion, I examined what Lonergan means by cognitional self-transcendence. I concluded the section by providing a brief sketch of cognitional self-appropriation, which was then applied to the levels of experiencing, understanding, and judging. I hope that the importance of this procedure, which Lonergan readily admits must be performed by oneself, has become clear.

1.4. Rational Self-Consciousness and the Extension of Self-Appropriation

There is a fourth qualitatively distinct level of human conscious intentionality, one that is characterized by the operations of evaluating, deliberating, deciding, and acting. Lonergan calls this fourth level responsible or rational self-consciousness. Human consciousness emerges at its fullest on this level. At play on the fourth level of consciousness is the principle of self-control, which is “responsible for [the] proper

251 Method in Theology, 19.
252 Insight, 362.
253 Ibid., 13.
255 Method in Theology, 9.
256 Insight, 651.
functioning on the first three levels.” 258 Self-control manifests itself in the measure that one is attentive or inattentive in experiencing, intelligent or unintelligent in one’s investigations, reasonable or unreasonable in one’s judgments. 259

On this fourth level of consciousness, the unrestricted, detached, disinterested, pure desire to know “extends its sphere of influence from the field of cognitional activities through the field of knowledge into the field of deliberate human acts.” 260

Walter Conn summarizes this phenomenon in this way:

Our desire to know and our achievement of knowledge is not an end point. There is more. Our knowing is oriented toward action… Our experiencing, understanding, and judging are directed not just to what is, but to what can be done, not just to knowing reality, but to creating reality, and creating ourselves in the process. 261

In a real way, the stakes are raised at the fourth level of consciousness. The subject’s operations at this level have the potential to take the subject beyond the cognitional self-transcendence described above and, instead, achieve “a self-transcendence that is real.” 262

In Method in Theology, Lonergan calls this variety of self-transcendence “moral.” 263

Human beings “emerge as persons” on this level. 264 One’s character, one’s personal essence is now at stake. 265 On the fourth level of consciousness, one has to “decide for oneself what one is to make of oneself.” 266

This is the level of consciousness characterized by freedom and responsibility. 267

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258 Method in Theology, 121.
259 Ibid.
260 Insight, 622.
263 Method in Theology, 104.
264 Ibid., 10.
266 Method in Theology, 121.
267 Ibid., 121.
In the introduction to *Insight*, Lonergan intimates the importance of extending the range of self-appropriation to the operations that are present on the fourth level. Lonergan writes:

The crucial issue is an experimental issue, and the experiment will be performed not publicly but privately. It will consist in one’s own rational self-consciousness clearly and distinctly taking possession of itself as rational self-consciousness. *Up to that decisive achievement all leads. From it all follows.*

At least one of the things that follows from this particular enterprise of self-appropriation is that it is the foundation of Lonergan’s notion of the possibility of ethics. In *Understanding and Being*, Lonergan claims that the “notion of the possibility of ethics has its grounds in the extension of self-appropriation from the subject as knowing to the subject as both knowing and doing.” Patrick Byrne, in his “*Analogical Knowledge of God and the Value of Moral Endeavor,*” stresses the importance of the subject’s self-appropriation of what he calls “the structure of ethical intentionality.” By exploring this structure, I will be able to simultaneously shed light on the substance and importance of the level of rational self-consciousness.

The activities of evaluating, deliberating, deciding, and acting significantly build upon the work of the antecedent operations that take place on the prior levels of consciousness. Lonergan writes, “It is quite true that objective knowing is not yet authentic human living; but without objective knowing there is no authentic living; for one knows objectively just insofar as one is neither unperceptive, nor stupid, nor silly; and one does not live authentically inasmuch as one is either unperceptive, stupid, or

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269 *Understand and Being*, 226.
270 Patrick H. Byrne, “*Analogical Knowledge…,*” 109-110.
silly.” 271 A little later in the same piece, Lonergan continues, “If any authenticity we achieve is to radiate out into our troubled world, we need much more objective knowing than men commonly feel ready to absorb.” 272 One should note that authenticity, or authentic human living, consists in self-transcendence. 273 Cognitional self-transcendence, then, is a necessary but not sufficient condition for the “real” or “moral” self-transcendence that can be achieved on the fourth level of consciousness.

Precisely what sort of objective knowledge is needed in order to put oneself in a position to morally transcend oneself? 274 This prior question needs to be met before I can explore Lonergan’s structure of ethical intentionality and the operations that are present on the fourth level of consciousness. Consequently, I will now very briefly examine the domains of both common sense and theoretical knowing.

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272 Ibid., 221.
274 Lonergan was well-attuned to the fact that personally acquired or “immanently generated knowledge is just a small fraction of what any civilized man knows or thinks he knows.” There is a symbiosis between our immanently generated knowledge and our beliefs. He further maintains, “We have no possibility of sorting out how much of each of our judgments rests on what we know and how much is influenced by the context given us by our language, our milieu over the years, what has been accumulated over the centuries, the millennia.” Please see: Bernard Lonergan, “The Human Good,” Philosophical and Theological Papers 1965-1980, Collected Works of Bernard Lonergan, Vol. 17, Ed. Robert C. Croken and Robert M. Doran (Toronto, University of Toronto, 2004), 341. Italics his. An adequate analysis of Lonergan’s notion of beliefs is beyond the scope of this paper.
1.5. Practical Common Sense and Theoretical Intelligence

As there are theoretical fields like physics, chemistry, and biology, there is also the practical field of human events and relationships that Lonergan calls common sense. This distinction in fields is the product of a more basic distinction within human intelligence, for the latter can be both speculative and practical. I will discuss common sense intelligence first and then briefly compare and contrast it with theoretical intelligence.

Lonergan bluntly writes, “Common sense is practical.” It is practical in the sense that it “seeks knowledge, not for the sake of the pleasure of contemplation, but to use knowledge in making and doing.” Common sense intelligence is a specialization of intelligence in the particular and concrete, as opposed to the universal and abstract. Lonergan maintains that it is “the vague name given to the unknown source of a large and floating population of elementary judgments which everyone makes, everyone relies on, and almost everyone regards as obvious and indisputable.” Its business is daily life, the familiar world of what Lonergan calls “things for us,” and its terms are derived from everyday experience. These terms are constant and include descriptions such as “visible shapes and spectrum of colors, the volume, pitch, and tone of sounds, the hot and cold, wet and dry, hard and soft, slow and swift.”

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275 *Insight*, 234-235.
276 Ibid., 621.
277 Ibid., 232.
278 Ibid.
279 Ibid., 198-199.
280 Ibid., 314.
281 Ibid., 255.
282 Ibid., 201.
283 Ibid., 321.
284 Ibid.
Common sense’s “apparently secure and modest undertaking”\textsuperscript{285} is to understand things in terms of describing their relations to us, which is tantamount to understanding things as they “enter into the concerns of man.”\textsuperscript{286} This domain of ordinary description, as Longeran calls it, has as an object what is to be known by concrete judgments of fact.\textsuperscript{287} Similar to other objects of knowledge, it is reached by the self-correcting process of learning.\textsuperscript{288} The proper domain of common sense is precisely this descriptive field of concrete, particular matters of fact, which is “divided up and parcelled out among the men and women familiar with its several parts.”\textsuperscript{289} Common sense does not entirely reside in the mind of any one individual.\textsuperscript{290} It has to be acquired and for this reason it is not possessed equally by all.\textsuperscript{291}

To shed light on the nature of common sense, Longeran contrasts it with scientific theoretical intelligence.\textsuperscript{292} Unlike common sense, science has theoretical aspirations, which embrace an advance “from description to explanation, from things as related to our senses, through measurements, to things as related to one another.”\textsuperscript{293} Scientific inquiry departs “from the familiar to the unfamiliar, from the obvious to the recondite.”\textsuperscript{294} Science’s heuristic assumptions “anticipate the determination of natures that always act in the same fashion under similar circumstances, and as well the determination of ideal

\textsuperscript{285} Ibid., 232. Italics mine. It is interesting that Longeran adds the word “apparently” to his description of common sense’s enterprise. As I will discuss below, common sense’s undertaking can actually end up being alarmingly immodest and insecure, for it is subject to bias.
\textsuperscript{286} Ibid., 317.
\textsuperscript{287} Ibid.
\textsuperscript{288} Ibid.
\textsuperscript{289} Ibid., 444.
\textsuperscript{290} Ibid., 236-237.
\textsuperscript{291} Ibid., 322.
\textsuperscript{292} He also contrasts common sense knowing with mathematical knowing, but for the sake of simplicity, I will only mention science. Please see: \textit{Understanding and Being}, 84-88; \textit{Insight}, 196-204.
\textsuperscript{293} Ibid., 201.
\textsuperscript{294} Ibid., 202.
norms of probability from which events diverge only in a nonsystematic manner."  

Science is typified by both utilizing a technical language with unambiguously defined terms and aiming to arrive at generalizations that “offer a premise from which correct deductions can be drawn.” These generalizations express the scientist’s “rounded set of insights that holds in every instance or none at all.”

Lonergan argues that both science and common sense’s generalizations are arrived at through a process of collaboration. Focusing on the common sense form of collaboration, which is fundamentally a communal collaboration in the self-correcting process of learning, Lonergan notes that human beings are “born into a community that possesses a common fund of tested answers.” Insights that were generated by previous generations accumulate and are then handed down to later generations. The common sense generalizations that have emerged from past generations can take the form of proverbs, which “communicate pointers that ordinarily it is well to bear in mind.” They admit of numerous exceptions, but do not lose their validity in virtue of that fact, for they are a “more or less invariant element in variable relations.” Each fresh, concrete situation demands that an individual call upon the available accumulated storehouse of previous insights and add complementary insights of his own that will meet the situation’s precise requirements.
What is common in common sense is “not some list of general truths about which all men can agree.”\textsuperscript{305} Nor is it “some list of particular truths about which all men can agree.”\textsuperscript{306} Instead, the common element is “a collaboration in the erection of a basic structure by which, with appropriate adjustments, each individual is enabled to fill out his individual list of particular truths.”\textsuperscript{307} Lonergan classifies common sense as a “multiple-purpose and multiple-adjustable tool that can be employed in all sorts of ways but never is actually to be employed without the appropriate adjustment being made.”\textsuperscript{308} As a result, common sense is a remarkably flexible type of intelligence that allows one to have the capacity to adapt to and successfully meet the immediate challenges posed in a given concrete situation.

Common sense, then, is inherently incomplete since it needs those appropriate adjustments.\textsuperscript{309} Lonergan affirms that common sense “consists in a basic nucleus of insights that never is utilized without the addition of at least one further insight into the situation at hand.”\textsuperscript{310} The generalizations of common sense consist of an incomplete set of insights that the individual draws upon in every concrete situation, but the generalizations become “proximately relevant only after a good look around has resulted in the needed additional insights.”\textsuperscript{311} Exactly which insight or insights an individual chooses to draw from this accumulated common fund in a given situation is shaped by

\textsuperscript{305} Ibid., 324.
\textsuperscript{306} Ibid.
\textsuperscript{307} Ibid.
\textsuperscript{309} Insight, 199.
\textsuperscript{310} Ibid., 598.
\textsuperscript{311} Ibid., 199.
“his capacity, his interests and his energy.”\textsuperscript{312} For these reasons, common sense is endlessly variable.\textsuperscript{313}

Another important feature of common sense that differentiates it from science is that it varies according to one’s occupation, social group, place, and time.\textsuperscript{314} Differentiations within science are due to theoretical differences within different departments.\textsuperscript{315} With respect to common sense, Lonergan observes, “At a given place, in a given job, among a given group of people, a man can be at intelligent ease in every situation in which he is called upon to speak or act.”\textsuperscript{316} However, that man’s achievement “is relevant only to its environment.”\textsuperscript{317} If you remove that man from the milieu to which he has become accustomed and place him instead “among others in another place or at another job,” awkwardness and hesitancy will unavoidably ensue until “he has accumulated a fresh set of insights.”\textsuperscript{318} This is why Lonergan argues that common sense’s methodological precepts do not consist of generalizing or arguing from analogy, but at building up and retaining a core of habitual understanding that is to be adjusted by further learning in each new situation that arises.”\textsuperscript{319} One should note that, in contrast to common sense knowers, if one removed the scientist or another theoretical knower from his environment, his explanatory insights would still remain universally valid.

Perhaps the starkest difference between science and common sense is one of attitude. What one considers to be the criterion of the relevance of further pertinent questions marks what Lonergan calls “the great divide between a scientific attitude and a

\textsuperscript{312} Ibid., 198.
\textsuperscript{313} Lonergan, “Merging Horizons: System, Common Sense, Scholarship,” 52.
\textsuperscript{314} \textit{Insight}, 598.
\textsuperscript{315} Ibid., 204.
\textsuperscript{316} Ibid., 203.
\textsuperscript{317} Ibid.
\textsuperscript{318} Ibid.
\textsuperscript{319} Ibid., 322.
commonsense attitude.” Due to the fact that the scientist “aims at ultimate explanation,” he persistently asks why “until the ultimate explanation is reached.” The man of common sense, however, cuts off his questioning as soon as “further inquiry would lead to no immediate appreciable difference in the daily life of man.” Lonergan underscores how the man of common sense’s inquiry is intensely interested and restricted by noting, “Descriptively, what does a man of common sense do when you start raising theoretical problems? He’ll either excuse himself, or he’ll ask you, ‘What’s the good of it?’” A common sense knower pursues knowledge motivated by a desire to live, or to develop more intelligent and successful ways of living.

The man of common sense’s inquiry, then, is informed by a pragmatic criterion of success. The pertinence of the further questions in a common sense inquiry is constrained by whether the questions are directed at answers that make an immediate, palpable difference. Lonergan calls this “the supreme canon of common sense,” which is that further questions are restricted to “the realm of the concrete and particular, the immediate and the practical.” The further pertinent questions that the man of common sense raises and the subsequent insights that emerge from those questions “are bounded by the interests and concerns of human living, by the successful performance of daily

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320 Ibid., 320.
321 Ibid.
322 Ibid., 320-321.
323 Understanding and Being, 311.
324 Ibid., 86.
325 Ibid., 320.
326 Joseph Flanagan, Quest for Self-Knowledge, 70.
327 Insight, 318.
328 Ibid., 201.
tasks, by the discovery of immediate solutions that will work.”\textsuperscript{329} Stated simply, common sense understanding does not seek “strict universality, but general utility.”\textsuperscript{330} Despite the differences between science and common sense, there is an innate, intimate complementarity between them. The two types of knowing are “the functionally related parts within a single knowledge of a single world.”\textsuperscript{331} Lonergan claims that science and common sense are essentially “partners.”\textsuperscript{332} Science comprehensively grasps the intelligibility of the concrete that common sense deals with effectively.\textsuperscript{333} It is the successful cooperation between science and common sense “that constitutes applied science and technology, that adds inventions to scientific discoveries, that supplements inventions with organizations, knowhow, and specialized skills.”\textsuperscript{334} The rational choice is not between science and common sense, rather “it is a choice of both, of science to master the universal, and of common sense to deal with the particular.”\textsuperscript{335}

1.6. Evaluating and Deliberating

Imagine that one has successfully made a concrete judgment of fact that something is so. According to Lonergan, another kind of question spontaneously emerges, indicating that there is still more to be known. One no longer wonders whether the “it” in the “Is it so?” question is so. That “it” was the content of one’s direct insight, which, prior to the judgment of fact, possessed a hypothetical status: what was grasped by

\begin{thebibliography}{99}
\bibitem{329} Ibid.
\bibitem{331} \textit{Insight}, 323.
\bibitem{332} Ibid.
\bibitem{333} Ibid.
\bibitem{334} Ibid.
\bibitem{335} Ibid., 203.
\end{thebibliography}
an act of understanding was a unity or relationship that was possibly relevant to the previously experienced and questioned data. Now, one’s judgment of fact serves, as it were, as a new “it,” for one spontaneously wonders, “What is to be done about it?” Patrick Byrne calls a “What can I do?” question a practical question. One knows that something is so, now one spontaneously wants to further know what one could practically do about it. Lonergan notes that this level is evaluative. Practical questions, as Byrne makes clear, “extend a process of coming to know a situation into a process of practical response to the situation as known.”

Obviously, this suggests that human beings can be oriented in a practical direction by which they seek not simply “what is,” but also “what might be.” Human knowing, likewise, can be practical in the sense that “its concern is with something to be done and with the reasons for doing it.” One’s previous reflective insights, by which one came to judge that something was so, appear to have a latent practical function. In Chapter 10 of *Insight*, Lonergan proclaims, “The remarkable fact about reflective insight is that it can make use of those more rudimentary elements in cognitional process to reach the virtually unconditioned.” It appears that the operations on the fourth level of consciousness can make use of the fruit of one’s prior cognitional work for further cognitional and, ultimately, performative purposes.

336 Early Works on Theological Method I, 432.
337 Ibid., 431.
338 Patrick H. Byrne, “Analogical Knowledge…,” 115.
339 Early Works on Theological Method I, 431.
340 Patrick H. Byrne, “Analogical Knowledge…,” 115.
342 *Insight*, 635.
343 Ibid., 306.
Evaluating, for example, seems to resemble brainstorming. In light of a nucleus of concrete judgments of fact, one attempts to mentally work out hypothetical, possible courses of action that could be performed. One’s storehouse of concrete judgments of fact can be used to “size up” a situation and thereby offer assistance to one’s evaluating efforts. Insofar as one’s concrete judgments of fact are correct, one’s idea of what is going on will be accurate. To the extent that one’s grasp of what is going on is accurate, one will be in a better position to further grasp what practically could be done. The operations at the first, second, and third levels of consciousness take on a special

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344 Byrne mentions that “practical insights presuppose processes or structures of conscious activities that result in practical insights.” Patrick H. Byrne, “Analogical Knowledge…,” 112. I am defining the operation of evaluating in this way based upon Lonergan’s comment, “On the fourth level, there arises the further question, What is to be done about it, What am I to do? This level is evaluative.” Please see: Early Works on Theological Method I, 431. Byrne situates what I am calling the operation of evaluating under the larger umbrella of the structured sequence of operations known as deliberating. Byrne argues that deliberating “is not just a single act or operation of consciousness, but a structured sequence of conscious operations.” (Byrne, “Analogical Knowledge…,” 111). There is ample textual evidence to support Byrne’s claim about deliberation. For example, Lonergan mentions “the evaluation in the judgment of value itself,” which runs contrary to my use of the term since I place evaluating before the judgment of value, not coalescing with it. (Bernard Lonergan, “The Human Good,” 340). Another example can be discovered in Method in Theology, where Lonergan writes, “There is the responsible level on which we are concerned with ourselves, our own operations, our goals, and so deliberate about possible courses of action, evaluate them, decide, and carry out our decisions.” Here, the operation of evaluating appears to take place after or simultaneously with the operation of deliberating. (Method in Theology, 9. Italics mine). A third example can be found in Lonergan’s “The Subject,” where he writes, “Results proceed from actions, actions from decisions, decisions from evaluations, evaluations from deliberations, and all five from the existential subject, the subject as deliberating, evaluating, deciding, acting, bringing about results.” (Bernard Lonergan, “The Subject,” 84). However one elects to define the operations of evaluating and deliberating, clearly there are operations that are operative before one has a practical insight and deliberates over whether one should carry out the proposed course of action. Namely, one is attempting to discern (or evaluate) what the proposed course of action could be, not yet whether one should perform the course of action.

345 Patrick H. Byrne, “Analogical Knowledge…,” 113-115. As Byrne makes clear, one should not overlook the difficulty in grasping the virtually unconditioned. He writes, “Of course it is one thing to work out a formal criterion for the correctness of insights, such as there being no further pertinent questions. It is quite another to dedicate oneself to the enormous, personal struggle required in order to develop the self-awareness and honesty needed for discerning whether or not there are lurking questions one has overlooked or fears one must face.” (Byrne, “Analogical Knowledge…,” 114).

346 Indeed, one will also be in a position to deliberate more effectively as well, discerning what should be done.
significance when one considers their ramifications on the operations at the fourth level of consciousness.  

Suppose that one has grasped a possible course of action. Evaluating has reached its term and one has had a practical insight. Byrne defines a practical insight as “an act of intelligence by means of which a person comes up with some idea about what she or he might do.” Lonergan points out that these practical insights share similarities with factual and speculative insights, such as the way in which they result from questioning one’s experiences. Practical insights also grasp “some intelligible unity or correlation,” like factual and speculative insights. Third, all three types of insight are met by a subsequent question for reflection.  

Nevertheless, practical insights differ from factual and speculative insights because they do not reveal “the unities and relations of things as they are, but the unities and relations of possible courses of action.” As such, the follow-up question to a practical insight is not “Is it so?,” but rather “Shall I do it?” This time, the “it” is the content of the practical insight, which is a hypothetical, possible course of action. The question provokes one to assess the value or worthwhileness of performing the possible

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347 Patrick H. Byrne, “What is Our Scale of Value Preference?,” Lonergan Workshop, Vol. 21, Ed. Fred Lawrence (2009), 46. Byrne notes that “as we deliberate, the seriousness of being certain about the facts looms ever more important.” In another work, Lonergan writes, “We aim at what is good. To know the good we have to know the real; to know the real we have to know the true; to know the true we have to understand; to understand we have to attend to the data.” Please see: Early Works on Theological Method I, 435.
348 Ibid., “Analogical Knowledge…,” 112. Italics mine. One has to wonder about the extent to which practical insights are “a dime a dozen.”
349 Insight, 632.
350 Ibid.
351 Ibid., 633.
352 Ibid. Italics mine.
353 Ibid. Please see also: Byrne, “Analogical Knowledge…,” 111-115.
354 Patrick H. Byrne, “Analogical Knowledge…,” 115.
proposed course of action.\textsuperscript{355} The “Shall I do it?” question intends a judgment of value, an affirmation or denial of the value of performing that action.\textsuperscript{356}

The “Shall I do it?” question evokes another operation on the level of rational self-consciousness to assist with the effort of arriving at a judgment of value: the operation of deliberating.\textsuperscript{357} In \textit{Insight}, Lonergan seems to call this operation “practical reflection.”\textsuperscript{358} Simply because one has grasped a possible course of action by way of a practical insight does not necessitate that one automatically and blindly executes it.\textsuperscript{359}

Further pertinent questions can be raised about the situation at hand, the proposed course of action itself, and one’s motives for performing the action.\textsuperscript{360} The extensive and potentially indefinite nature\textsuperscript{361} of these further questions accentuates the complexity and richness of the operation of deliberating. Joseph Flanagan notes that “deliberating can go on indefinitely because you are dealing not with a fact,” but instead with a possible course of action “that will not be actualized unless you decide to do so.”\textsuperscript{362}

One’s need for posing further questions about the situation at hand depends upon one’s familiarity with that situation as well as “the seriousness of the consequences of the proposed course of action, with the uncertainties and the risks it involves.”\textsuperscript{363} Lonergan also claims that one’s “antecedent willingness or unwillingness to assume responsibility for the consequences and to run the risks” associated with the proposed course of action

\textsuperscript{355} Joseph Flanagan, \textit{Quest for Self-Knowledge}, 198.
\textsuperscript{356} Patrick H. Byrne, “Analogical Knowledge…,” 115.
\textsuperscript{357} Ibid., “What is Our Scale of Value Preference?,” 46. Byrne helpfully defines deliberating as “a matter of asking and answering ever further pertinent questions about possible courses of action, heading toward a grasp of a course of action as a virtually unconditioned value.”
\textsuperscript{358} \textit{Insight}, 633-635.
\textsuperscript{359} Ibid., 633.
\textsuperscript{360} Ibid., 633-634.
\textsuperscript{361} Ibid., 635.
\textsuperscript{362} Joseph Flanagan, \textit{Quest for Self-Knowledge}, 198.
\textsuperscript{363} \textit{Insight}, 633.
can influence the need to subject the situation at stake to further questioning.\textsuperscript{364} One’s deliberations could, in other words, incite one to balk at making a judgment of value and realize that the gravity or riskiness of the situation at hand demands more accurate judgments of fact concerning it.

One could also deliberate by submitting the proposed course of action to further scrutiny. Perhaps the course of action is still fuzzy and more details are needed, such as its successive steps, its alternatives, its consequences, its overall feasibility, and the probability or certainty of its various features.\textsuperscript{365} One may need to ask about what the proposed course of action excludes.\textsuperscript{366}

Third, one may need to deliberate about and marshal one’s underlying motives for performing the proposed course of action. Lonergan provides a hint of how intensive this form of deliberation could be:

\begin{quote}
Would [the proposed course of action’s] execution be agreeable? Are there other features to compensate for its disagreeableness? What is its utility? How desirable are the goals to which it is useful?... Does the proposed act come under the accepted order? If not, is it merely egoistic, or is it a contribution to the initiation of an improvement in the accepted order? Or if it does come under the accepted order, is not that order in need of improvement? Is not this the time to begin improving things?\textsuperscript{367}
\end{quote}

Lonergan appears to give special prominence to these last two forms of deliberating. He writes, “But I become rationally self-conscious inasmuch as I am concerned with reasons for my own acts, and this occurs when I scrutinize the object and investigate the motives

\textsuperscript{364} Ibid.
\textsuperscript{365} Ibid.
\textsuperscript{366} Ibid.
\textsuperscript{367} Ibid., 634.
of a possible course of action.”368 Precisely what are these questions for deliberation intending?

1.7. Values, Judgments of Value, Feelings

The chief question for deliberation, “Shall I do it?,” and all of the sub-questions for deliberation touched upon above, intend value.369 In Method in Theology, Lonergan argues that a value is what is intended in questions for deliberation.370 One should recall that intending “is neither ignorance nor knowledge but the dynamic intermediary between ignorance and knowledge.”371 It is “a conscious movement away from ignorance and towards knowledge.”372 One is intending, not knowing, value when one “asks whether this is truly and not merely apparently good, whether that is or is not worth while.”373 Those questions are what Lonergan calls questions for deliberation.374 Thus, as Joseph Flanagan observes, deliberating “raises the whole new question of values.”375

Values are only known in judgments of value.376 In order to better understand values, it will be helpful to discuss them within the context of judgments of value. Lonergan argues that three components unite in a judgment of value. First, there is “knowledge of reality and especially human reality.”377 Second, there are intentional responses to values. Third, there is “the initial thrust towards moral self-transcendence

368 Ibid.
369 Patrick H. Byrne, “What is Our Scale of Value Preference?,” 46.
370 Method in Theology, 34.
372 Ibid.
373 Ibid.
374 Method in Theology, 34.
376 Joseph Flanagan, Quest for Self-Knowledge, 198.
377 Patrick H. Byrne, “What is Our Scale of Value Preference?,” 46.
378 Method in Theology, 38.
constituted by the judgment of value itself." 378 I will briefly explore each of these components in turn.

First of all, judgments of value “have to have a basis in concrete human reality.” 379 They “presuppose knowledge of human life, of human possibilities proximate and remote, of the probable consequences of projected courses of action.” 380 The previous section on common sense intelligence and its complementarity with theoretical intelligence circumscribed much of the “knowledge of human life” that Lonergan has in mind here. Without this basis in human reality, one would “get into moral idealism, beautiful ideas with terrific appeal, but unfortunately, if it were put into practice, the results would be disastrous.” 381 Judgments of value depend upon previous judgments of fact. 382

The two types of judgment share certain structural similarities with one another. First, both the “Shall I do it?” and the “Is it so?” questions intend “one or the other of a mutually exclusive pair of conscious operations,” namely an affirmation or denial. 383 Second, both judgments “proceed from self-transcending subjectivity, from attention, intelligence, reasonableness, and responsibility.” 384 Third, for the judgment of value to be responsible, and for the judgment of fact to be reasonable, both need to be “motivated by reflective understanding of the virtually unconditioned.” 385 In the former case, practical

378 Ibid.
379 Early Works on Theological Method I, 511.
380 Method in Theology, 38.
382 Joseph Flanagan, Quest for Self-Knowledge, 199.
383 Patrick H. Byrne, “Analogical Knowledge…,” 115.
or value reflective understanding\textsuperscript{386} needs to grasp “the possible course of action as virtually unconditional value,”\textsuperscript{387} while in the latter case, reflective understanding needs to grasp “the prospective judgment as virtually unconditioned.”\textsuperscript{388} Byrne explains:

\begin{quote}
Just as a reasonable judgment of the correctness of an insight rests upon the insight as virtually unconditioned because invulnerable, so also responsible affirmation of a possible course of action as valuable emanates from grasp of the practical insight as virtually unconditioned (‘there being no further pertinent questions’).\textsuperscript{389}
\end{quote}

One can responsibly affirm or deny that a possible course of action is valuable when one has had what Brian Cronin calls a “deliberative insight.” Such an insight, according to Cronin, is a “cognitive activity by which we grasp the sufficiency of the evidence for the positing of a judgment of value.”\textsuperscript{390} As noted above, Lonergan was keenly aware of the possibility that proposed courses of action could be examined in meticulous detail, which could raise an overwhelming array of further pertinent questions.\textsuperscript{391} As a result, one’s attainment of a deliberative insight and subsequent affirmation or denial of the worth of a proposed course of action could be obstructed or indefinitely postponed.

Nevertheless, one should note the way in which the self-correcting process of learning is operative in the process of deliberation and the subsequent grasp of a deliberative insight, just as it was operative in the process of reflecting and the subsequent grasp of a reflective insight. A prospective judgment of value may need to be complemented and modified by further insights. The further pertinent questions that are entertained in the self-correcting process give rise to further and complementary

\textsuperscript{386} Ibid., “What is Our Scale of Value Preference?,” 46. I discovered the term “value reflective understanding” from this article.
\textsuperscript{387} Ibid., “Analogical Knowledge…,” 116.
\textsuperscript{388} \textit{Insight}, 305.
\textsuperscript{389} Patrick H. Byrne, “Analogical Knowledge…,” 116. Italics his.
\textsuperscript{390} Brian Cronin, \textit{Value Ethics: A Lonergan Perspective} (Nairobi: Consolata Institute of Philosophy, 2006), 187.
\textsuperscript{391} \textit{Insight}, 634-635.
insights.\textsuperscript{392} Significantly, as it will be argued below, the crucial role of intentional feelings in the deliberating process is that they determine which questions a subject will consider to be pertinent.

In addition to these structural similarities, there are differences between the two types of judgment. One of the important differences between judgments of value and judgments of fact is that the former lacks a capacity of its own to come to an end.\textsuperscript{393} Whereas the processes of reflection that occur on the third level of consciousness “reach their natural end in judgments of fact,” the processes of deliberation on the fourth level of consciousness “do not reach their natural end in judgments of value.”\textsuperscript{394} Actually arriving at and making a judgment of value provides “but an initial thrust towards moral self-transcendence.”\textsuperscript{395} One should note that judgments of value are merely a cognitional milestone that requires the performance of further operations on behalf of the subject: deciding and doing.\textsuperscript{396} Nevertheless, they are a significant milestone, for they are “the door to one’s fulfillment or to one’s loss.”\textsuperscript{397}

In order to effectively examine the operations of deciding and acting, as well as what Lonergan means by moral self-transcendence, it is necessary to probe how intentional responses to values fit into this discussion. These intentional responses to values are one of the components that comes together in a judgment of value.\textsuperscript{398} What are intentional responses to values?

\textsuperscript{392} Mark J. Doorley, \textit{The Place of the Heart in Lonergan’s Ethics} (Lanham: University Press, 1996), 81.
\textsuperscript{393} \textit{Insight}, 634. Clearly, judgments of fact and value differ in content as well. As Lonergan writes, “[O]ne is about what exists, the other is about what ought to be; one is what is so, the other is what one approves or disapproves.” Please see: \textit{Early Works on Theological Method I}, 510.
\textsuperscript{394} Patrick H. Byrne, “Analogical Knowledge…,” 116.
\textsuperscript{395} Ibid. Italics his; \textit{Method in Theology}, 38.
\textsuperscript{396} \textit{Insight}, 635.
\textsuperscript{397} \textit{Method in Theology}, 39.
\textsuperscript{398} Ibid., 38.
Longeran gives a clue to answering this question when he states, “Intermediate between judgments of fact and judgments of value lie apprehensions of value. These apprehensions of value occur in feelings that are intentional responses to values.”399 Not all feelings are intentional responses to values. In an effort to comprehend what Lonergan means by a feeling being an intentional response to value, I will quickly explore the divisions that Lonergan makes within the domain of feelings.

Broadly speaking, Lonergan divides feelings into two general classes: non-intentional states and trends, and intentional responses.400 Non-intentional states and trends are not evoked by objects.401 Both non-intentional states and trends occur “independently of perception or apprehension.”402 An example of a non-intentional state is fatigue. Fatigue, like other non-intentional states, has a cause, but it does not require any “perceiving, imagining, or representing [of] the cause” to be felt.403 Hunger is an example of a non-intentional trend, which has a goal. One simply feels hungry, but does not yet know that what one needs is something to eat.404 Values are not apprehended in these states and trends.405

Feelings that are intentional responses arise from an object, as they are answers to what is intended, apprehended, or represented.406 There are two main classes of these feelings. On the one hand, there are feelings that are intentional responses to “the

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399 Bernard Lonergan, “What Are Judgments of Value?,” 144.
400 Method in Theology, 30.
402 Mark J. Doorley, The Place of the Heart in Lonergan’s Ethics, 44.
403 Method in Theology, 30.
406 Method in Theology, 30.
agreeable or disagreeable, the satisfying or dissatisfying. Lonergan calls these feelings “self-regarding.” This subset of intentional feelings regards “the already achieved, de facto constitution of the subject.” In other words, what is made present “by intentional responses to the subjectively satisfying or dissatisfying is the constituted subject.”

On the other hand, there are intentional responses to values, which Lonergan calls “self-transcending” feelings. These feelings “‘break in’ like an ‘other’ upon the self as constituted.” Byrne calls attention to how Lonergan distinguishes these feelings from value questions, which intend values, and value judgments, which know values. According to Lonergan, “value properly so-called is something that calls one to transcend oneself.” Those feelings that are intentional responses to value beckon or invite one to transcend oneself. What is made present “by an intentional response to value is that for the sake of which the subject transcends himself as constituted.”

Self-regarding feelings include pleasures and pains, desires and fears. Self-transcending feelings recognize excellence. This distinction enables one to comprehend what Lonergan means when he says that self-transcending feelings can “reveal values to us.” A self-transcending feeling is a felt recognition that something is valuable. A self-regarding feeling, on the other hand, merely reveals that something is pleasurable or painful, desirable or fearful. This distinction is tacitly contained in the

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407 Ibid., 31.
409 Patrick H. Byrne, “Analogical Knowledge…,” 118.
410 Mark J. Doorley, The Place of the Heart in Lonergan’s Ethics, 81.
411 Method in Theology, 31.
413 Patrick H. Byrne, “Analogical Knowledge…,” 119.
414 Ibid., “What is Our Scale of Value Preference?,” 47.
415 Ibid., “What Are Judgments of Value?,” 141.
416 Mark J. Doorley, The Place of the Heart in Lonergan’s Ethics, 81.
418 Ibid.
419 Ibid.
“Shall I do it?” question. As Lonergan affirms, “The mere fact that we ask it points to a distinction between feelings that are self-regarding and feelings that are disinterested.”420

Lonergan argues that self-regarding feelings are ambiguous because they may or may not be simultaneously responding to a value.421 He declares, “You can have a response to something disagreeable and nonetheless go ahead and do it without too much lamentation.”422 In Method in Theology, Lonergan observes, “Most good men have to accept unpleasant work, privations, pain, and their virtue is a matter of doing so without excessive self-centered lamentation.”423 Thus, one can feel that some course of action is disagreeable, but nevertheless judge that the course of action is truly valuable and then decide to move forward with putting that course into action.

Returning to self-transcending feelings, Lonergan claims that these feelings respond to values “in accord with some scale of preference.”424 As a result, Lonergan makes a distinction between vital, social, cultural, personal, and religious values, in an ascending order.425 Vital values include health, strength, grace, and vigor. We spontaneously prefer them over “avoiding the work, the privations, the pains involved in acquiring, maintaining, restoring them.”426 The spontaneity embedded in this preference is captured in Lonergan’s comment, “We feel contempt for a person who destroys his own health.”427

420 Ibid.
421 Ibid., “What Are Judgments of Value?,” 141.
422 Ibid.
423 Method in Theology, 31.
424 Ibid.
425 Ibid.
427 Ibid.
Social values, such as the good of order that conditions the vital values of the whole community, are preferred by the community to the vital values of single individuals. This preference is made manifest not by the community’s choice to sacrifice individuals, but instead by the community’s expecting and demanding individuals to be willing to sacrifice themselves. Lonergan conceives of the social as “a way of life, a way in which men live together in some orderly and therefore predictable fashion.” This orderliness can be observed “in the family and in manners, in society with its classes and elites, in education, in the state and laws, in the economy and technology, in the churches and sects.” What social values assure is the “recurrent achievement of hosts of vital values.” As Byrne states, “[The social] includes the kinds of institutions and patterns of human interaction which are responsible for cooperative production and distribution of goods, services, information, and learning.”

Cultural values address the fact that while human beings live and operate, “they also have to find a meaning and a value in their living and operating.” As Lonergan states, “Not on bread alone doth man live.” Culture, for Lonergan, is “the meaning of a way of life.” Human beings wish to “discover and to express the appropriateness, the meaning, the significance, the value, and the use of their way of life as a whole and in its

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428 Ibid. I will discuss the good of order in greater detail below.
429 Ibid.
431 Ibid.
435 Method in Theology, 32.
This discovery and expression constitutes the cultural. Lonergan notes that a culture “stands to social order as soul to body, for any element of social order will be rejected the moment it is widely judged inappropriate, meaningless, irrelevant, useless, just not worthwhile.” A given culture does not stand within practicality, but above it.

Personal values are human subjects themselves in their self-transcendence. They are realized in one’s loving and in one’s being loved. These values consist in one being an originator of values in oneself and in one’s milieu as well as “an inspiration and an invitation to others to do likewise.”

At the top of the scale of values lie religious values, which “are at the heart of the meaning and value of man’s living and man’s world.” They are the values that “arise in and from real self-transcendence in response to God.” This self-transcendence toward God is an ultimate in self-transcendence. Lonergan notes that the love of God is a unique, total loving that “actuates the unrestricted character of human conscious intentionality.” This full love of God is also joy and peace. It is transformative, for it banishes “the emptiness, the unrest, the alienation, the flight from one’s depths that haunt lives lived without God.” Lonergan writes, “Full love, joy, peace enhance all one’s virtues, press against all one’s defects; they make a man a power for good, zealous in achieving.”

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437 Ibid.
438 Ibid.
439 *Insight*, 261.
440 *Method in Theology*, 32.
442 *Method in Theology*, 32.
443 *Early Works on Theological Method I*, 550.
444 Ibid., 550-551.
445 Ibid., 551.
446 Ibid.
to God as fulfillment within the human person, and that of being a source of proper human action in this world.447

1.8. The Importance of Religious and Moral Conversion in the Process of Moral Self-Transcendence

The question still remains: Relative to one’s effort to transcend oneself morally, what is the impact or relevance of intentional feelings? To adequately answer this question, one needs to understand Lonergan’s notion of a horizon. One’s horizon is “the limit, the boundary, where one’s concern or interest vanishes.”448 Similar to how, in a visual horizon, “there is a periphery beyond which one cannot see,” each subject has an existential horizon, the periphery of which “marks the difference between what is relevant or meaningful and what is irrelevant or meaningless.”449 Lonergan notes that one’s horizon is “the world, the totality of objects, with which I can promptly deal in virtue of my acquired habits.”450 In another work, Lonergan succinctly summarizes a person’s horizon as “the boundary of what he knows and values.”451 One’s horizon at any point in time is determined by one’s “past insights, past judgments of fact, past judgments of value, past decisions and past actions.”452

Mark Doorley makes the useful distinction between the basic horizon and a relative horizon. The basic horizon “is constituted by the unrestricted desire to know and choose the good,” while a relative horizon “is a limited achievement in response to this

447 Ibid., 551-552. This latter point will be explored below.
448 Topics in Education, 90.
449 Mark J. Doorley, The Place of the Heart in Lonergan’s Ethics, 78.
450 Early Works on Theological Method I, 13.
452 Mark J. Doorley, The Place of the Heart in Lonergan’s Ethics, 78.
unrestricted desire. Lonergan makes clear that this distinction is grounded in an inherent, ineluctable tension within the subject:

[I]t is the opposition between the world of sense of man the animal and, on the other hand, the universe of being to be known by intelligent grasp and reasonable affirmation. On the side of the subject, it is the opposition between a center in the world of sense operating self-centeredly and, on the other hand, an entry into an intelligibly ordered universe of being to which one can belong, and in which one can function, only through detachment and disinterestedness.

Inevitably, the subject functions within those two modes of operation. The subject as animal is characterized by perceiving and self-regarding intentional feelings, enjoying and suffering. Within this mode of operation, the subject functions as “a self-attached and self-interested center within its own narrow world of stimuli and response.” Conversely, insofar as the subject is carried by the pure desire to know, he finds himself confronted by a universe of being, one in which he is “not the center of reference, but an object to be coordinated with other objects.” Doorley emphasizes how this unavoidable tension “is not a negative characteristic to be overcome,” but is rather “a reminder of the limitation of any achievement.” Lonergan notes that human development is stamped by “a law of limitation and transcendence,” which is precisely this unavoidable tension between the subject as he is and the subject as he is to be.

The subject, in his animality, is dominated by intentional feelings of the self-regarding variety that only respond to the subjectively satisfying or dissatisfying. What is made present by these feelings is, as mentioned before, the constituted subject. On the
other hand, the subject, as carried by the pure desire to know and choose the good, is
dominated by intentional feelings of the self-transcending variety that respond to the “that
for the sake of which the subject transcends himself as constituted.” Insofar as one’s
feelings are self-transcending, one is oriented by one’s affectivity toward some value that
transcends one’s limited constitution.

As Byrne argues, the crucial role played by these intentional feelings is that they
can determine which questions are considered pertinent in one’s deliberating efforts. Intentional feelings, then, “establish a horizon in which deliberation occurs.”

Moreover, our other, prior cognitional operations, such as our experiencing,
understanding, and judging are laden with these intentional feelings. One’s “seeing,
hearing, touching, smelling, tasting, inquiring, imagining, understanding, conceiving,
formulating, reflecting, marshaling and weighing the evidence, [and] judging” are
informed and shaped by one’s intentional feelings. As such, they “fix the meaning of
what will count as further pertinent questions in concrete situations,” including those
questions for intelligence and reflection. The self-centered person allows intentional

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460 Ibid.
461 Patrick H. Byrne, “Analogical Knowledge…,” 120.
462 Ibid., 119.
463 Mark J. Doorley, The Place of the Heart in Lonergan’s Ethics, 84.
464 Early Works on Theological Method I, 427.
465 Patrick H. Byrne, “What is Our Scale of Value Preference?,” 48. Byrne’s insight here clears up some
potential confusion over what Lonergan meant when he wrote in Method in Theology, “Intermediate
between judgments of fact and judgments of value lie apprehensions of value. Such apprehensions are
given in feelings.” (Method in Theology, 37). On the basis of this passage, one might be tempted to
conclude that Lonergan thinks that intentional feelings necessarily fall within a temporal sequence:
experiencing, understanding, factual judging, intentional feelings, value judging. Second, one might also
conclude that Lonergan is arguing that intentional feelings only occur during the operations involved in
evaluating and deliberating, that is, during those operations that take place between factual judging and
value judging. Aside from running contrary to personal experience, other passages clearly reveal that both
of those conclusions are incorrect. For instance, in his Early Works on Theological Method I, Lonergan
writes, “And without feeling, all this business of experiencing, understanding, judging, deciding, is paper thin.” (Early Works on Theological Method I, 504). Perhaps even more decisively, Lonergan writes
elsewhere, “We spoke of experience, understanding, judging. Feeling is the first fundamental dimension
within which knowing emerges, and now we are working on the fourth level, namely, questions for
responses to what is subjectively satisfying to dominate his cognitional processes and “so
sets the criterion for the relevance of further questions.” Conversely, the subject that is
under the sway of self-transcending feelings will consider pertinent and entertain any
question that might bear upon the realization of value.

Embracing the appropriate criteria for further pertinent questions at each level of
consciousness is a consequence of moral conversion and, ultimately, moral self-
transcendence. Lonergan writes, “If basically one’s questions are of the self-regarding
type, then one has not attempted moral self-transcendence.” Lonergan states in Method
in Theology that moral conversion “changes the criterion of one’s decisions and choices
from satisfactions to values.” Moral conversion is about a turn away “from objects of
desire and fear as ultimate, to the normative, to what ought to be so whether one likes it
or not.” When one is morally converted, one has “ceased to need the carrot of desire
and the stick of fear.” Instead, one has “become a self-starter, a principle of
benevolence and beneficence, a genuine person whose words and deeds inspire and invite
those that know him or her to aspire themselves to moral self-transcendence, to become
themselves genuine persons.”

As one deliberates upon the “Shall I do it?” question and its further pertinent
questions, the morally converted person’s inquiry will not be constrained by what is
subjectively satisfying or dissatisfying. As a result, there will be a higher likelihood that

466 Mark J. Doorley, The Place of the Heart in Lonergan’s Ethics, 81.
467 Ibid., 82.
469 Early Works on Theological Method I, 14.
471 Ibid.
the morally converted person will be able to grasp a course of action as a virtually unconditioned value. In turn, there will be a higher probability that the morally converted person will realize value through his decisions and actions.

Moral conversion, like intellectual and religious conversion, consists of “repudiating characteristic features of an old horizon and beginning a new sequence that reveals ever greater depth and breadth and wealth.” But going beyond, transcending one’s old horizon is no easy feat. Lonergan contends that there is “an organized resistance” to being converted and, consequently, to transcending oneself. He writes:

Within one’s horizon, one’s ready-made world, one is organized, one has determinate modes of living, feeling, thinking, judging, desiring, fearing, willing, deliberating, choosing. But to move beyond one’s horizon in any but the most casual and insignificant fashion calls for a reorganization of the subject, a reorganization of his modes of living, feeling, thinking, judging, desiring, fearing, willing, deliberating, choosing. Against such reorganization of the patterns of the subject, there come into play all the conservative forces that give our lives their continuity and their coherence. The subject’s fundamental anxiety, his deepest dread, is the collapse of himself and his world.

This reorganization of the human subject that makes human development and self-transcendence possible “is not only advance into the known unknown but also a flight from anxiety and, in more marked instances, from uncanny feelings of horror, loathing, dread.”

Lonergan carefully notes that the temporal succession of conversions is typically not intellectual, moral, and then religious. Rather, religious conversion tends to come first, followed by moral conversion, and then intellectual conversion. Robert Doran maintains that religious conversion is “a process that frees one from the self-enclosure

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473 Method in Theology, 327-238.
474 Topics in Education, 90.
475 Insight, 556, note 3.
476 Method in Theology, 243.
that Lonergan calls radical lovelessness, which is the privation of total loving. To the extent that one is consumed by radical lovelessness, one is “persuaded that, in the last analysis and even if one has human companionship, one is finally alone in this universe, with no ultimate connection.” Lovelessness, at root, is about the isolation of the individual, a profound narrowing of one’s horizon. Within this cramped horizon, self-regarding intentional feelings are liable to shape one’s experiencing, understanding, judging, evaluating, deliberating, and deciding. Lonergan memorably captures this point in some notes that he wrote in 1963:

I am that for the sake of which I myself am perfected. My perfection is for the sake of me. My food is for the sake of me. My delight in eating is for the sake of me. My studies are for the sake of me. My good works are for the sake of me. If it is for the sake of me, there is no need to inquire further… The ultimate end is my happiness. Other things are chosen as means to attain this end.

Religious conversion radically transforms this narrow horizon and thus serves as a precondition for moral conversion. The essence of religious conversion is a “twofold process of being loved unconditionally [by God] and responding to that radical gift by cooperating in the process whereby one’s own loving becomes unconditional.” Lonergan describes this loving as one that is “without conditions, qualifications, reservations; it is with all one’s heart and all one’s soul and all one’s mind and all one’s strength.” The unrestricted character of this loving resembles the unrestricted character of human questioning, but it does not pertain to this world alone. It is, instead, an

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480 Ibid., 11.
481 Ibid., 13-14. In this essay, Doran does not cite the source of this quotation.
482 Ibid., 7.
483 Method in Theology, 242.
“otherworldly fulfillment, joy, peace, bliss.” The eye of this love “reveals values in their splendor, while the strength of this love brings about their realization.” Religious conversion, therefore, creates conditions that are rife for moral conversion, since it enables and sustains the subject to operate in a horizon in which self-transcending feelings are at home. As Doran writes, “Love establishes human consciousness, the consciousness of the individual, precisely as interpersonal.” Moreover, love reveals values to the subject that were previously unappreciated.

The other-centered focus of this love expands the subject’s horizon and enriches his intentional feelings to respond to values. Again, quoting Doran, “The issue is the orientation, the criterion, the basic and total horizon within which one makes one’s decisions, the self-constituting option to be a certain type of person. Is it all just for me?... Or is it all for a set of goals that transcend me and all narrow group interests, even if these goals are attained only by me.” Religious conversion transforms the subject “into a subject in love, a subject held, grasped, possessed, owned through a total and so an other-worldly love.” When this state of being in love is developed, it becomes “the fount of all one’s actions.” With religious conversion comes “a new basis for all valuing and all doing good,” a basis that paves the way for one to become morally converted and, later, to morally transcend oneself. For insofar as one is morally converted, one will be

484 Ibid.
485 Ibid., 243.
486 Ibid.
488 Method in Theology, 122.
490 Method in Theology, 242.
492 Method in Theology, 242.
493 In Method in Theology, Lonergan writes, “Conversion is the way to self-transcendence.” Please see: Method in Theology, 357.
ever more faithful to “the full dimensions of the scale of values” articulated above, and one will be in a more stable position to align one’s own scale of values to that normative scale.494

1.9. Moral Self-Transcendence, Deciding, Authenticity

Moral self-transcendence is the culmination of a complex process.495 Presupposed in this process is: 1) an accumulation of true judgments of fact reached through one’s own cognitional self-transcendence,496 2) the posing of the “What can I do?” practical question; 3) an accumulation of practical insights that answer the “What can I do?” question and provide the content of the “it” in the “Should I do it?” question; 4) a seeking for what is worthwhile497 by posing “Should I do it?” questions to oneself; 5) a cultivation of self-transcending feelings that enhances one’s ability to raise further pertinent questions at each level of consciousness, but most vitally at the level of

494 Robert M. Doran, “What Does Bernard Lonergan Mean by ‘Conversion’?,” 17. Byrne argues that moral conversion “should not be regarded as a shift away from absolute indifference in feelings regarding all values but as a shift within an individual’s actual, felt structure of value preference.” As such, moral conversion is not exclusively a matter of “overcoming absolute value indifference,” but instead is more about overcoming “partial or distorted value blindness.” (Patrick H. Byrne, “Which Scale of Value Preference?: Lonergan, Scheler, Von Hildebrand, and Doran,” Meaning and History in Systematic Theology: Essays in Honor of Robert M. Doran, S.J., Ed. John D. Dadosky (Milwaukee: Marquette University, 2009), 32). Mark Doorley arrives at a similar conclusion, “[O]ne is rarely, if ever, wholly under the sway of either self-regarding or self-transcending feelings. The norm is that one’s feelings pull one in various directions. For this reason it is necessary to understand the movement of one’s feelings correctly in order to judge which are responses to value and which are not.” (Mark J. Doorley, The Place of the Heart in Lonergan’s Ethics, 82).

495 In Method in Theology, Lonergan calls attention to how self-transcendence “has many parts and a long development.” Please see: Method in Theology, 35.

496 Method in Theology, 233. Lonergan claims that “cognitional self-transcendence is much easier than moral self-transcendence,” but that this does not mean that former is easy. Please see: Method in Theology, 122.

497 Ibid., 289.
deliberation;\textsuperscript{498} 6) being morally and religiously converted; 7) earnestly arriving at true judgments of value.\textsuperscript{499}

As Lonergan notes, however, a judgment of value only provides “the initial thrust towards moral self-transcendence.”\textsuperscript{500} Moral self-transcendence is not simply a matter of successfully asking and answering questions for deliberation, those that intend value. One also needs to live by the answers in order to effect in one’s living a moral self-transcendence.\textsuperscript{501} Consequently, one’s judgments of value need to be completed by the operation of deciding or choosing.\textsuperscript{502} Indeed, the deliberating process reaches its natural end in an act of deciding.\textsuperscript{503} As Lonergan writes, deliberating “does not come to an end once the object and motives of a proposed action are known; it comes to an end when one decides either in favor of the proposal or against it.”\textsuperscript{504} If one elects to postpone making a decision after one has grasped that a course of action is truly valuable, further questions emerge that prolong the deliberation process, such as “Why can’t I do this when I know that I should?”\textsuperscript{505}

Lonergan notes that there is an element of uncertainty and risk connected with our decisions, for one cannot know the effects or results that one’s decision will generate.\textsuperscript{506} Still, it is by way of deciding that one makes and becomes oneself. For this reason, Lonergan underscores the elements of freedom and responsibility that accompany our

\textsuperscript{498} Patrick H. Byrne, “Analogical Knowledge…,” 117.
\textsuperscript{499} Method in Theology, 233.
\textsuperscript{500} Ibid., 38. Italics mine.
\textsuperscript{501} Method in Theology, 104.
\textsuperscript{502} Patrick H. Byrne, “Analogical Knowledge…,” 116.
\textsuperscript{503} Ibid., 116.
\textsuperscript{504} Insight, 637.
decisions. He writes, “Because man determines himself, he is responsible; because the course of action determined upon and the process of determining are both contingent, man is free.” One did not necessarily have to be attentive, intelligent, and reasonable in arriving at true judgments of fact. Nor did one necessarily have to fall under the sway of self-transcending feelings and entertain the further pertinent questions that enabled one to deliberate effectively and grasp a course of action as truly valuable. Finally, one does not necessarily have to decide to put into action what one has judged to be truly valuable. What one decides to do, in other words, does not necessarily have to be consistent with what one knows is truly valuable. From the antecedent cognitional work to, especially, the culminating act of deciding, contingency is present each step of the way. Lonergan argues that freedom is a special kind of contingency, one that emerges “in the order of spirit, of intelligent grasp, rational reflection, and morally guided will.”

The responsible element that marks the operation of deciding is nicely captured by Byrne. He writes:

[W]hile all cognitional acts are constitutive of the subject, decisions are constitutive in the most profound and thoroughgoing way. Compilation of acts of experiencing constitute one as increasingly aware; accumulation of insights constitute one as learned and, when they combine with judgments which they ground, one is constituted as wise. But it is decisions that constitute the kind of being one is to be. Decisions constitute one as authentic or inauthentic…

When one has grasped that a course of action is truly valuable and subsequently decides to act in a way that is consonant with that judgment, one has morally transcended oneself

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507 Insight, 642.
508 Ibid., 715.
509 Ibid., 642.
510 Ibid. For a specimen of Lonergan’s treatment of the notion of freedom, please see: Insight, 639-656.
511 Patrick H. Byrne, “Analogical Knowledge…,” 116.
and thereby contributed to one’s formation as an authentic person. This important point warrants a few words of elaboration.

Our decisions give rise to dispositions and habits, and these habits and dispositions make oneself into a certain kind of person, one for which we are responsible. One can decide to be a drifter or an inauthentic person, one who is satisfied with simply being one of the crowd. Lonergan argues that the world is teeming with people of this sort. In this case, one’s decisions result in the creation of a person whose individuality is blurred, for one is limited by a concern over “consenting to be like everybody else, wanting to be like everyone else.” The drifter finds “security, assurance, peace of soul in being like everyone else.” The product of the drifter’s decisions is “another instance of the average man in a given milieu.” In an outline of a lecture on Martin Heidegger, Lonergan notes that the drifter wants “release from being one’s own self, [from] freely and responsibly discovering and realizing one’s own potentialities with all of the risk involved.” Unfortunately, drifters have not attempted moral self-transcendence since their questions for deliberation tend to be of the self-regarding type. As such, they disqualify themselves from becoming authentic individuals and they are responsible for that disqualification.

In contradistinction to the drifter, Lonergan pits the resolute, decisive, authentic person. In *Insight*, Lonergan identifies this type of person as possessing the quality of genuineness. Insofar as one is genuine or authentic, one “does not brush questions aside,

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smother doubts, push problems down, escape to activity, to chatter, to passive entertainment, to sleep, to narcotics." 518 The authentic person “confronts issues, inspects them, studies their many aspects, works out their various implications, contemplates their concrete consequences in one’s own life and in the lives of others.” 519 While one may respect “inertial tendencies as necessary conservative forces,” one does not accept the conclusion “that a defective routine is to be maintained because one has grown accustomed to it.” 520 Lonergan is sensitive to the fact that the authentic person may fear “the cold plunge into becoming other than one is,” but he is nonetheless “capable of assurance and confidence, not only in what has been tried and found successful, but also in what is yet to be tried.” 521 The authentic person possesses a certain amount of stamina, as he “grows weary with the perpetual renewal of further questions to be faced” and longs for rest. 522 Yet, despite faltering and failing, he is aware of his weaknesses and failures, and does not attempt to rationalize them away. 523 The authentic person’s decisions bring to light his own unique individuality 524 and they give rise to the reward of a happy conscience. 525

This beautiful sketch of the authentic or genuine person highlights the fragile nature of authenticity. Lonergan maintains that authenticity is never “some pure, serene, secure possession; it is always precarious, ever a withdrawal from unauthenticity, ever in danger of slipping back into unauthenticity.” 526 In large part, authenticity is “a matter of

518 Insight, 502.
519 Ibid.
520 Ibid.
521 Ibid.
522 Ibid.
523 Ibid.
525 Method in Theology, 35.
uncovering still more oversights, acknowledging still further failures to understand, correcting still more mistakes, repenting more and more deeply hidden sins.” As Robert Doran asserts, “Authenticity is achieved in self-transcendence, and consistent self-transcendence is reached only by conversion.” To be authentic, one needs to be consistently self-transcending. To be consistently self-transcending, one needs to “undergo a multiple and ongoing process of conversion.” The reason one needs to repeatedly undergo processes of conversion is attributable to one’s susceptibility to bias. Bias brings about the distinction between the self-transcending and the self-regarding. (I will examine the threefold bias of the practical subject in the next section).

It would be a mistake to conclude that Lonergan thinks that one’s responsibility is limited to one’s making of oneself. Human beings also have a responsibility “to the future of mankind.” Lonergan argues that the course of human history, like the universe at large, is in accord with emergent probability. What he means by that is that human history “is the cumulative realization of concretely possible schemes of recurrence in accord with successive schedules of probabilities.” Schemes of recurrence are “are circular relationships between events of kinds, such that if the events

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527 Method in Theology, 252.
529 Ibid.
530 Method in Theology, 231.
532 Insight, 712.
533 Ibid., 252-253.
535 Insight, 252.
536 Ibid.
occur once in virtue of circular relationships, then, other things being equal, they keep on recurring indefinitely.”537

Many human actions are recurrent and their recurrence is regular, though not inevitable. This regularity “is the functioning of a scheme, of a patterned set of relations that yields conclusions of the type: If an X occurs, then an X will recur.”538 Assuming that “there occurs an appropriate conjunction of abstract laws and concrete circumstances,” human schemes of recurrence will emerge and function automatically.539 Lonergan gives some examples of schemes of recurrence existing and functioning in the realm of human affairs:

- Children are born only to grow, mature, and beget children of their own.
- Inventions outlive their inventors and the memory of their origins.
- Capital is capital because its utility lies not in itself but in the acceleration it imparts to the stream of useful things. The political machinery of agreement and decision is the permanent yet self-adapting source of an indefinite series of agreements and decisions.540

One of the chief features of emergent probability is its “upward but indeterminately directed dynamism.”541 It is “upward” in the sense that “current innovations, whether natural or human, build upon earlier innovations.”542 It is “indeterminate” because “the part taken by this building process is unpredictable.”543

Lonergan argues that human affairs fall under the dominion of emergent probability in a unique way. As human intelligence develops, progressively “less importance attaches to the probabilities of appropriate constellations of

537 Ibid., 148.
538 Ibid., 235.
539 Ibid.
540 Ibid.
542 Ibid.
543 Ibid.
Instead, progressively more importance “attaches to the probabilities of the occurrence of insight, communication, persuasion, agreement, decision.” Human material and social conditions are not only intelligible, but also intelligent. Not only can they be understood, they are also increasingly the fruit of insight and decision. Lonergan dramatically notes that “man becomes for man the executor of the emergent probability of human affairs.” Rather than passively being shaped by his environment, “man turns to transforming his environment in his own self-development.” One’s insights are anticipations of possible schemes and one’s decisions bring about the concrete conditions of their functioning.

The upshot is that human beings, by their living and decisions, are inevitably “making their own personal contribution to the historical process.” Lonergan calls this an “historic authenticity.” Similar to how one can decide to morally transcend oneself and live an authentic existence, so too can one take seriously the “responsibility of man for man,” the notion that, collectively, human beings are responsible for the resultant social situation and the trajectory of human history. Lonergan writes, “In each stage of the historical process, the facts are the social situation produced by the practical intelligence of the previous generation.” The objective social situation at any point in

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544 Insight, 235-236.
545 Ibid., 236.
546 Ibid., 252.
547 Ibid.
548 Ibid.
550 Ibid.
551 Ibid., 305.
552 Ibid., “Natural Right and Historical Mindedness,” 169.
553 Insight, 254.
time “possesses the intelligibility put into it by those that brought it about.” Each individual’s decisions contribute to the direction in which history ultimately heads. This is one of the reasons why Lonergan stresses the importance of one’s personal authenticity, for without it genuine historic authenticity cannot be actualized. Since bias disrupts personal development and distorts the unfolding of human history, it is now necessary to examine the three biases of the practical subject.

1.10. The Three Biases

All human beings, according to Lonergan, are subject to bias, which is “a block or distortion of intellectual development.” Of interest in this study is the threefold bias that infects the commonsense intelligence of the practical subject: individual bias, group bias, and general bias. Although these biases are distinct from one another, they share at least one feature in common: they are all “aberrations of human understanding which exclude and repress insights, along with their further relevant questions they would have engendered.” Characteristic of the biased subject is a partial, though incomplete, development of intelligence that leads to an exclusion of correct understanding.

The three biases, to the extent that they are operative in oneself, hinder one from being able to act intelligently. If one cannot act intelligently, one cannot be expected to act reasonably. And if one cannot act reasonably, one cannot be expected to act

554 Ibid.
556 Method in Theology, 231.
557 Insight, 651.
559 Insight, 246.
responsibly.\textsuperscript{560} Insofar as people fail to be attentive, intelligent, reasonable, and responsible, a breakdown ensues “in the individual case, the group case, and the general case.”\textsuperscript{561} The irrational and irresponsible behavior that follows from this breakdown “creates a non-intelligible, absurd situation, where everything is out of place.”\textsuperscript{562} The three biases and the resultant absurd situation will now be discussed.\textsuperscript{563}

The root of the first bias, individual bias, is found in the tension between personal or animal spontaneity\textsuperscript{564} on the one hand, and spontaneous intersubjectivity - along with the unrestricted, detached, disinterested intelligence that is characteristic of the pure desire to know - on the other.\textsuperscript{565} The egoist, who is afflicted with individual bias, is not altogether “devoid of the disinterestedness and detachment of intelligent inquiry.”\textsuperscript{566} When it comes to intellectually engaging and striving to satisfy the appetites afforded by his personal, perhaps culturally-refined spontaneities, the egoist exceeds many others in his ability to “face issues squarely and to think them through.”\textsuperscript{567} If the egoist is concerned about something, he permits “the immanent norms of intelligent inquiry [to]
overrule any interference from desire or fear.” 568 Within his own “restricted terms of reference,” the egoist permits the free play of intelligent inquiry. 569

The egoist’s horizon of concern or interest is too restricted. As Lonergan writes, “With remarkable acumen one solves one’s own problems. With startling modesty one does not venture to raise the relevant further questions, Can one’s solution be generalized? It is compatible with the social order that exists?” 570 Thus, the egoist’s area of interest “is confined to the insights that would enable him to exploit each new situation to his own personal advantage,” often at the expense of others. 571 Questions arising from “the demands of intersubjective spontaneities and springing from the love of others” are summarily blocked. 572

Human beings not only naturally and spontaneously seek to satisfy their own appetites, they are also naturally and spontaneously predisposed to “help others in the attainment of their satisfactions.” 573 This latter form of spontaneity, which Lonergan calls intersubjective spontaneity, means that “human persons spontaneously take care of one another.” 574 Similar to how “one spontaneously raises one’s arm to ward off a blow to one’s head, so with the same spontaneity one reaches out to save another from falling.” 575 This intersubjective spontaneity is so primordial that it prompts Lonergan to declare, “It is as if ‘we’ were members of one another prior to our distinctions of each from the

568 Ibid.
569 Ibid.
570 Ibid.
573 *Insight*, 244.
575 *Method in Theology*, 57.
85 There is, then, an earlier, prior “we” that precedes the more familiar “we,” the one which results “from the mutual love of an ‘I’ and a ‘thou’.” An elemental feeling of belonging together makes manifest this primordial “we.” Lonergan warns that the efficacy of this primordial “we” diminishes rapidly with distance in place or time.

The egoist consciously orient himself in such a way that “he devotes his energies to sizing up the social order, ferreting out its weak points and its loopholes, and discovering devices that give access to its rewards while evading its demands for proportionate contributions.” Above all, what the egoist attempts to do is delegitimize and make unnecessary the well-being of others and employ his intelligence for the sake of his own aggrandizement. It is in this sense that individual bias is an incomplete development of intelligence.

Individual bias is the interference that disallows the “complete free play” of intelligent inquiry. Those afflicted by individual bias give free rein to the unrestricted desire to know, but only with respect to the whims of his or her own personal spontaneities. In short, the successful egoist is one who overcomes “both the drive of intelligence to raise the relevant further questions that upset egoistic solutions and, as well, the spontaneous demands of intersubjectivity.”

Lonergan provocatively argues that the egoist is not “totally unaware of his self-deception.” Amidst all of the egoist’s rationalizations and reassurances that his intelligent selfishness is justified, he cannot completely quell “the dynamic criterion of
the further question [that is] immanent in intelligence itself.”

The egoist is marked by a peculiar disingenuousness, for he knows the value of the unrestricted, detached, disinterested desire to know through the pursuit of his own narrowly-conceived interests, yet he simultaneously elects to cut the reach of the desire short.

Group bias, the second bias, is blinder, more secure, and more powerful than individual bias. Lonergan observes that “individual bias is, of course, something that is always disapproved of by all the groups. But when you have group bias, well, everyone in the group is all for it.” Whereas individual bias was characterized by an effort to overcome the natural and spontaneous intersubjective fellow-feeling, group bias finds itself supported by such feelings. To get a clearer grasp of group bias, it will be helpful to examine Lonergan’s discussion of social progress.

Social progress is a “cyclic and cumulative process that results when situations give rise to insights revealing new possibilities.” These new possibilities, when grasped and implemented, lead to new courses of action. The new courses of action, in turn, produce new situations, and those new situations give rise to further insights that reveal additional possibilities.

This cyclical and cumulative process “admits of an indefinite unfolding.” As long as a community of individuals possesses a self-transcending orientation, the mistakes of the past will be illuminated and, to some extent, eliminated. More worthwhile

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584 Ibid., 247.
585 Ibid.
587 Early Works on Theological Method I, 507.
588 *Insight*, 247.
590 Ibid.
591 Ibid.
courses of action will be grasped in response to existing problems. Human intelligence will be able to effectively guide the unfolding of the historical process so that it is marked by cumulative progress. Lonergan declares that such progress would potentially be inevitable if all of these responses were made by pure intelligences. Human progress in this fashion is a fact, but only a first approximation to fact, for it is stymied and marred by bias.

In theory, the course of social change could consist of “a succession of insights, courses of action, changed situations, and fresh insights.” Under such circumstances, the key distinction would be between “fresh insights that are mere bright ideas of no practical moment and, on the other hand, the fresh insights that squarely meet the demands of the concrete situation.” A community would embrace and participate in a collaborative laboratory that welcomed insights and rigorously tested them for their efficacy and accuracy. But individuals can freely decide to develop a self-regarding orientation, which results in the promotion of a special type of intelligence, one in which the particular interests of a group or groups are promoted, encouraged, and even imposed on others.

Under these conditions, an interference in the development of practical common sense emerges, which Lonergan calls group bias. When this bias is functioning, groups are not completely content with the criteria of an insight squarely meeting the demands of the concrete situation. Instead, biased groups are predisposed to sort through pools of practical insights in an effort to determine which serve their interests and which do not.

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592 *Insight*, 248.
594 *Insight*, 249.
595 Ibid.
Consequently, truly practical insights “have to be divided into operative and inoperative; both satisfy the criteria of practical intelligence; but the operative insights alone go into effect for they alone either meet with no group resistance or else find favor with groups powerful enough to overcome what resistance there is.”

At stake here is that group bias prevents practical intelligence from being truly practical. As Doran declares, “[Group bias] is responsible for the neglect or rejection of those practical insights that could genuinely meet social problems, but that call for the renunciation of narrow group or class interests, or the subordination of these interests to some larger viewpoint embracing the whole community.” It is not enough to simply have a good idea, even if that idea is precisely what is needed at the time. Under the conditions created by group bias, the timely idea cannot “simply emerge from the man on the spot, diffuse, give rise to new potentialities in a chain reaction.” Instead, it “has to combine with power, with wealth, with popular notion, before it can be realized.”

The historical process, when plagued by group bias, becomes grotesquely distorted. The social situation that results “does not correspond to any coherently developed set of practical ideas.” Instead, it merely reflects “the fraction of practical ideas that were made operative by their conjunction with power, the mutilated remnants of once excellent schemes that issued from the mill of compromise, the otiose structures that equip groups for their offensive and defensive activities.” Groups can offensively strike down practical plans of action that serve the common good, or defensively protect

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597 Insight, 249.
598 Robert M. Doran, Theology and the Dialectics of History (Toronto: University of Toronto, 1990), 370.
599 Topics in Education, 60.
600 Ibid.
601 Ibid.
602 Ibid.
the status quo in the face of practical insights that “reveal [the group’s] well-being to be excessive or its usefulness at an end.”603 Group bias is particularly potent when it comes to changes in economic and political institutions.604

Over time, the historical process, burdened by group bias, unfolds in such a way that some groups are favored and others are neglected. The longer group bias functions, “the smaller the group it favors and the larger the group it neglects.”605 This can result in what Arnold Toynbee calls “the schism in the body social.”606 Yet, Lonergan argues that this distorted development “creates the principles for its own reversal”607 because eventually the social situation will deteriorate to the point where “there is no need to call upon experts and specialists to discover whether anything has gone wrong, nor even to hit upon a roughly accurate account of what can be done.”608 In other words, it will become blatantly obvious that things have gone awry. The neglected groups will come to discover and later champion the practical insights and ideas that were neglected by the favored groups. Lonergan calls this deterioration the shorter cycle of decline.609

More intractable and grave than group bias is the third bias, which Lonergan calls general bias. At its core, general bias stems largely from “a failure on the part of practical knowers to accept the fact that common sense knowing is a limited, specialized form of knowing.”610 The extraordinary success and productivity of common sense, which “engenders and maintains enormous structures of technology, economics, politics, and

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603 Ibid., 248.
604 Ibid., 251.
607 Insight, 249.
608 Ibid., 250.
609 Ibid., 252.
610 Joseph Flanagan, Quest for Self-Knowledge, 85.
culture,” is glaringly vulnerable to cherishing the illusion that it is omnicompetent. The fact that common sense works, it gets things done, incites people to relegate the value of theoretical knowing. Lonergan notes that common sense is “easily led to rationalize its limitations by engendering a conviction that other forms of human knowledge are useless or doubtfully valid.” If a current pattern of behavior is leading to the generation of satisfactory results, common sense pats itself on the back and then rises to meet the next immediate challenge. While this is an integral part of human living, common sense “is very, very weak at paying attention to long-term results and consequences.” As Lonergan affirms, “The general bias of common sense prevents it from being effective in realizing ideas, however, appropriate and reasonable, that suppose a long view or that set up higher integrations or that involve the solution of intricate and disputed issues.”

To use an analogy of vision, common sense is far-sighted. Up close, it sees the present concrete situation with utmost acuity. However, with regard to issues that are far away, the long-term issues, common sense is profoundly blind. Common sense needs the corrective lens of theoretical knowing to enable human beings to consummately function intelligently. Lonergan uses the analogy of a court of law to accentuate this point when he writes, “One can entrust common sense with the task of a juror; one cannot ask it formulate the laws of a country, to argue cases in its courts, to decide on issues of procedure, and to pass sentence on criminals.” Theory anchors the latter four activities,

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611 Insight, 232.
613 Insight, 251.
614 Early Works on Theological Method I, 508.
615 Insight, 253.
616 Ibid.
617 Ibid., 445.
while common sense, with its predilection for the immediate, practical, and concrete is well-equipped to handle the task of the juror.

Portraying general bias as a certain kind of blindness is only part of the story, however. In addition to what Lonergan calls “sins of omission,” general bias involves “sins of refusal” as well.618 Lonergan points out that general bias involves not only the dismissal of theoretical ideas that could be potentially profitable in the future, it also involves actively and willingly refusing to entertain and having disdain for those same ideas. Common sense’s “complacent practicality” banishes ideas that fail to address the satisfaction of immediate desires or the alleviation of present fears.619 Lonergan provides a snapshot of this pernicious attitude in *Insight*:

To advance common sense is to restrain the omnivorous drive of inquiring intelligence and to brush aside as irrelevant, if not silly, any question whose answer would not make an immediately palpable difference… [T]he man of common sense (and nothing else) is ever on his guard against all theory, ever blandly asking the proponent of ideas what difference they would make, and if the answer is less vivid and less rapid than an advertisement, then solely concerned with thinking up an excuse for getting rid of the fellow. After all, men of common sense are busy. They have the world’s work to do.620

As one can imagine, this additional refusal on the part of common sense makes the illness of the general bias all the more severe. It is not just a matter of common sense knowers being immoderately caught up in the fruits of their specialized intelligence. It also consists of common sense knowers pretending “to be omniscient knowers who tend to spurn and depreciate theoretical knowers as impractical idealists lost in their abstractions.”621 Lonergan expresses concern over the general bias of common sense by

618 Ibid., 253.
619 Ibid.
620 Ibid., 201-202.
wondering how the world’s work could ever be done efficiently and effectively if men of exclusive common sense never bother themselves with the contributions of theory.622

Devoid of the guidance of theoretical intelligence, the human social situation, rather than progressing intelligently, deteriorates cumulatively.623 This is what Lonergan calls the longer cycle of decline. Whereas the shorter cycle of decline consists of dominant biased groups selectively making inoperable ideas that may detract from their well-being, but nevertheless have potential for serving the common good in some capacity, the more pervasive longer cycle of decline consists of a general “neglect of ideas to which all groups are rendered indifferent.”624 Regardless of whether one is part of a dominant or depressed group, insofar as one is afflicted with general bias, one will exhibit a certain apathy, if not hostility, towards those theoretical ideas that suppose a long view. What is “unnecessary and disastrous” is not practical knowing itself, but the “exaltation of the practical.”625

This neglect accumulates over time as each generation inherits an increasingly unintelligible social situation that is composed of “quick fix” solutions and “arbitrary fragments,” which the previous generation’s biased common sense used to palliate the symptoms of the social situation that they inherited. The situation can be likened to hammering shingles over the holes found in the rotting roof of the house that one inherited from one’s parents, and then bequeathing this same house to one’s offspring. General bias sets up an underlying opposition between “the decisions that intelligence and reasonableness would demand and the actual decisions, individual and common, that

622 Insight, 202.
623 Ibid., 254.
624 Ibid., 252. Italics mine.
625 Ibid., 263.
are made."  Remote and, to some extent, uncertain future payoffs discourage the implementation of intelligent and reasonable courses of action, especially when those courses of action place demands on the biased subject’s time.  

To the extent that “the courses of action that men choose reflect either their ignorance or their bad will or their ineffectual self-control, there results the social surd.”  The social surd, which Lonergan also calls a “social dump,” is a “tangled skein of intelligibility and absurdity in concrete situations.”  What Lonergan means by a surd is “something that lacks the intelligibility one would expect an object to have.”  One would expect the social situation to be an object that reflects the wheel of progress moving forward “through the successive transformations of an initial situation in which are gathered coherently and cumulatively all the insights that occurred along the way.”  But when the social situation becomes a dump “in which are heaped up the amorphous and incompatible products of all the biases of self-centered and shortsighted individuals and groups,” the likelihood of occurrences of fruitful insights decreases.  Without occurrences of fruitful insights, the subsequent cumulative development becomes characterized by a lack of intelligibility. One cannot abstract from the unintelligibility embedded in the biased social situation if one wants to consider the facts as they are.  

Lonergan argues that the more the social surd expands, the more irrelevant theoretical knowing seems to become. The link between theoretical enterprises like

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626 Ibid., 651.
627 One would think that claims on the biased subject’s money would, too, be an unattractive part of a proposed course of action.
628 Insight, 711.
630 Insight, 712.
631 Early Works on Theological Method I, 298.
633 Ibid.
634 Insight, 255.
culture, religion, and philosophy to the social situation is intelligibility. The social surd creates conditions that encourage culture to retreat into the ivory tower, religion to become an inward matter of the heart, and philosophy to glitter “like a gem with endless facets and no practical purpose.” The permeation of the social surd leads to the seeming irrelevance of intelligence, reason, and the pure desire to know to the world as it stands. The incoherence of the social situation causes the dynamic progress of intelligence in both the personal and community spheres to be replaced first by sluggishness and ultimately by stagnation.

Worse still, the expansion of the social surd generates objective evidence for false conclusions, which can taint the entire enterprise of theoretical knowing. Lonergan argues that the longer cycle of decline can infect theoretical knowers, resulting in the major surrender of the unrestricted, detached, and disinterested desire to know. Describing this surrender, Joseph Flanagan writes:

Theoreticians grow up in the same concrete social order and disorders as practical knowers, and so theory can be subject to similar pressures and disorientations which may gradually compromise the different long-term objectives and disinterested desires that initiate and sustain their passion for learning. Gradually the goal of disinterested knowing is no longer an open-ended inquiry and critical reflection, but some truncated version of it, which, in the limit, surrenders its own norms and objectives. In such a limit case, instead of the disinterested desire providing norms for judging the situations, the reverse occurs, as the facts of the socially disordered situations become the basis and provide norms for an empirical science of human behavior.

The pure desire to know can come to be supplanted by a type of theorizing whose basis is derived from the data provided by the disordered social situation. Theory, under these

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635 Ibid., 254-255.
636 Understanding and Being, 236.
637 Ibid., 254.
638 Early Works on Theological Method I, 299.
639 Joseph Flanagan, Quest for Self-Knowledge, 87.
circumstances, is confined to the “empirical, scientific, realistic” and norms for “questioning and understanding… are to be subordinated to the concrete disordered performances of different communities.” Theoretical intelligence can eventually come to be viewed as a mere instrument for developing a new philosophy, a new ethics, and a new religion that conforms to the objective facts. As Lonergan explains, “As the objective facts get worse and worse, the new ethics, the new religion, the new philosophy, keep getting worse and worse. That is the social surd expanding in the world of community and in the world of theory.”

Understandably, this perversion of the whole enterprise of theorizing has deleterious effects on human living. Stripped of its endless resources to formulate creative, intelligent, and beneficial theories, the detached and disinterested desire to know becomes radically uncritical. There are no available criteria to enable one to differentiate between social achievement and social surd. Individuals still have the freedom to follow the dictates of reason as they see fit, but they must also cultivate “the virtue of tolerance to the equally reasonable views and actions of others.” Having transformed our naturally endowed unrestricted desire to know into a spectator of incoherent events that creates theories grounded in what Lonergan calls false facts, human beings muddle through one crisis and into another and eventually become crippled by the mounting unintelligibility that has come to saturate the social situation.

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640 Insight, 253.
641 Joseph Flanagan, Quest for Self-Knowledge, 88.
642 Early Works on Theological Method I, 299.
643 Ibid., 255.
644 Ibid., 256.
645 Ibid.
646 Understanding and Being, 236. Here, Lonergan defines a false fact as “the actual existence of what should not be.”
647 Insight, 445.
Lonergan surmises that eventually our only recourse will be to enlist the help of the totalitarian, “who takes the narrow and complacent practicality of common sense and elevates it to the role of a complete and exclusive viewpoint.” The totalitarian degrades all forms of intellectual independence to the status of myths, perhaps signifying that he is the embodiment of the general bias.

Lonergan sketches a haunting subsequent course of the longer cycle of decline, should it proceed unchecked. One totalitarianism may call forth another until some parties decide that war is a better alternative to the present situation. Depending on how that war plays out, a variety of conditions will follow, ranging from total destruction to the creation of a single world empire that “inherits both the objective stagnation of the social surd and the warped mentality of totalitarian practicality.”

While this description of the longer cycle of decline is harrowing, Lonergan nevertheless emphasizes that it is not inevitable. Briefly, his prescription to combat decline is to develop positions and reverse counterpositions. Every human discovery can be formulated as either a position or counterposition, and conflicts between the two can disorient human minds and derail one’s efforts to live authentically. Both of them have to do with the personal development of the subject, most notably whether one is intellectually, morally, and religiously converted.

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648 Ibid., 256.
649 Ibid.
650 Ibid., 257.
651 Ibid., 258.
652 Ibid., 712-713.
653 Ibid., 654.
654 Method in Theology, 252.
655 Ibid., 249; Bernard Lonergan, “Method in Catholic Theology,” 36-37; 40.
Positions are “statements [that are] compatible with intellectual, moral and religious conversion.”656 They express “the dynamic structure of the subject qua intelligent and qua reasonable”657 and, as such, they invite further development.658 One of the key implications of the positions of intellectual conversion, for example, is “the contention that the chief feature of the universe is its dynamism: emergent probability.”659 Since positions invite development, they can later be expressed in different ways and joined with other positions into more comprehensive unities.660 Lonergan notes that a perfect expression of a position would be entirely free from any taint of counterpositions and that this accomplishment is rare.661

Counterpositions, on the other hand, “are statements [that are] incompatible with intellectual or moral, or religious conversion.”662 They invite reversal because they contradict the dynamic structure of the subject. When one expresses a counterposition, one is involved in “a queer type of contradiction.”663 The contradiction is not between different statements that one makes, but rather between the statements that one makes and the subject that one happens to be.664 One strives to be intelligent and reasonable, yet one’s counterpositions are deficient in intelligibility and reasonableness. The way to

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656 *Method in Theology*, 249.
658 *Insight*, 713.
660 *Insight*, 713.
661 Ibid.
662 *Method in Theology*, 249.
664 Ibid.
reverse a counterposition is to remove the elements that are incompatible with intellectual, moral, or religious conversion.\textsuperscript{665}

This solution, however, can be difficult to achieve in practice. Various features of counterpositions make them resistant to single-stroke reversals. For instance, counterpositions can expand by the unfolding of their logical implications. They also have a knack for recognizing other counterpositions and uniting with them in a common cause. Counterpositions are also known to shift their ground, which deflects reversal efforts to their various manifestations instead to their roots.\textsuperscript{666} As I will argue in the next chapter, perhaps the single most important prevailing counterposition leading up to the subprime mortgage crisis was the claim that house prices will interminably rise. This nagging, recalcitrant counterposition was completely at ease in a horizon informed by general bias.

1.11. The Invariant Structure of the Human Good

In a 1962 lecture given at Regis College, Lonergan prefaces his discussion of the human good by citing how St. Thomas Aquinas and Aristotle both observed that “true and false are in the mind, while good and evil are in things.”\textsuperscript{667} Consequently, when one asks about the good, one is asking about the concrete.\textsuperscript{668} The good is always concrete and never an abstraction, just like reality.\textsuperscript{669} The concreteness of the good applies whether

\textsuperscript{665} Method in Theology, 249.
\textsuperscript{666} Insight, 713.
\textsuperscript{667} Early Works on Theological Method I, 34.
\textsuperscript{668} Ibid., 34-35.
\textsuperscript{669} Ibid., 494.
one is considering the good in its total range or, with a narrower focus, simply in terms of the human good.\(^{670}\)

In general, the good is human insofar as it is realized through human apprehension and decision.\(^{671}\) This is a significant point because it is “with regard to the human good that development occurs fundamentally.”\(^{672}\) Human apprehension develops, which enables one age to understand things better and to know more than the preceding age.\(^{673}\) Human decisions, for their part, are authentic or inauthentic, depending upon the subjective circumstances enumerated above.\(^{674}\) The human good, as a result, is a history. It is a developing, cumulative process “where there is both advance of apprehension, and distortion, aberration, due to evil” or bias.\(^{675}\)

In order to apprehend the human good, Lonergan argues that “one needs something in the way of a scheme, something that will suggest to one the great variety of questions connected with thinking about the human good.”\(^{676}\) Interestingly, Lonergan affirms that if one’s conception of the human good is limited to the definition of “that which all men desire,” then one is “finishing the question off a little too briefly.”\(^{677}\) That nominal definition of the human good, however accurate, may nevertheless be ineffective when it comes to generating further pertinent questions, hence the need for a scheme or

\(^{670}\) Ibid., 35.
\(^{671}\) Topics in Education, 32. Lonergan uses the term “choice” here.
\(^{672}\) Early Works on Theological Method I, 35.
\(^{673}\) Topics in Education, 32.
\(^{674}\) Ibid. Lonergan uses the terms “good” and “evil” in this context.
\(^{675}\) Ibid.
\(^{676}\) Early Works on Theological Method I, 494-495.
\(^{677}\) Ibid., 495.
structure. Lonergan maintains that his scheme or structure of the human good “provides topics for exploring different aspects” of it.

The invariant structure of the human good is remarkably rich and flexible, so much so that it can be found in any human society and is compatible with any sort of technological, economic, political, cultural, and religious development. It is an open structure, one that is large enough “to include both subject and object, to unite the subjective and the objective, the individual and the social.” The structure has three levels that are related to one another in an interlocking fashion. Each level features individual potentialities and actuations, as well as some sort of social mediation, and an end or object. Lonergan argues that the structure is based on nature, “on man’s needs and abilities, his capacity for development, his native freedom.” He writes:

On a first level one considers the needs and capacities of individuals, their operations which within society become cooperations, and the resultant recurrent instances of the particular good. On a second level, one considers their plasticity and perfectability, their training for assuming roles and performing tasks within already understood and accepted modes and styles of cooperating, and their actual performance which results in the functioning or malfunctioning of the good of order. On a third level one considers individuals as free and responsible, adverts to their basic operations for self-transcendence or for alienation, examines their personal relations with other individuals or groups within the society, and notes the terminal values they bring about in

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678 Lonergan notes in *Topics in Education* that the definition of the good as that which everything seeks “does not exhaust the notion of the good.” Please see: *Topics in Education*, 29. Lonergan appears to argue that defining the human good as that which all human beings seek or desire does not, likewise, exhaust the notion of the human good. Joseph Flanagan nicely brings out this point when he writes, “People have spontaneous desires for sweaters, but they do not desire textile industries.” The implication seems to be that the human good embraces, but is not limited to, that which human beings desire. Please see: Joseph Flanagan, *Quest for Self-Knowledge*, 220.

679 *Early Works on Theological Method I*, 495.

680 *Topics in Education*, 27.

681 *Method in Theology*, 52.

682 *Topics in Education*, 39-40.

683 Ibid., 39.

684 *Early Works on Theological Method I*, 35.

685 Ibid., 40.
themselves and encourage in others.\textsuperscript{686} Each of the three levels will now be examined in turn.

On the first level, under the heading of individual potentiality, need is conjoined with the capacity for operating.\textsuperscript{687} Needs are very broadly conceived as “anything anyone wants,” not merely what necessity demands.\textsuperscript{688} Human beings actuate their capacity to operate in order to meet their needs. Lonergan argues, though, that the vast majority of human beings spend most of their lives cooperating in some way or other, instead of operating. Robinson Crusoe, alone and stranded on an island, operated to meet his needs.\textsuperscript{689} Since most human beings live in groups, however, their operating, to a notable extent, is socially mediated by cooperating.\textsuperscript{690} Whether operating or cooperating, what these efforts procure are instances of the particular good.

According to Lonergan, particular goods are what most people think about when they discuss the good.\textsuperscript{691} Particular goods can be things, events, satisfactions, or operations.\textsuperscript{692} Generally speaking, to the extent that an object or activity meets a human want or need on a particular occasion, that object or activity is a particular good.\textsuperscript{693} Lonergan writes, “Regarding the particular good, we may say that any good is particular insofar as it responds to, or is the good of, this particular appetite. This apple, this dinner, this instance of beatific vision, are all instances of the particular good. They are objects of

\begin{itemize}
\item \textsuperscript{686} \textit{Method in Theology}, 359.
\item \textsuperscript{687} \textit{Method in Theology}, 48.
\item \textsuperscript{688} Bernard Lonergan, “The Human Good,” 342.
\item \textsuperscript{689} \textit{Early Works on Theological Method I}, 36.
\item \textsuperscript{690} \textit{Method in Theology}, 48.
\item \textsuperscript{691} \textit{Topics in Education}, 33.
\item \textsuperscript{692} Ibid., 34.
\end{itemize}
an appetite, a desire." Particular goods can change over time. The breakfast cereal, cornflakes, was not a particular good in the nineteenth century, though it came to be a particular good in the twentieth century.

What accounts for the shift from the first level of the structure of the human good to the second level is the fact that the need for particular goods is recurrent. Human intelligence “insists upon some assurance of regularity, recurrence, security.” One not only wants breakfast, one also wants it every day. The individual potentiality on this level is the human capacity for development that is made possible by our plasticity and perfectibility. These capacities enable individuals to adapt to changing circumstances, accommodate new insights, and to develop the skills necessary to meet the ever-shifting demands imposed by institutions.

Our plasticity and perfectibility is actuated by way of acquiring habits and developing skills. Habits, according to Lonergan, ground the possibility of specializations. One is capable of acquiring a specialization “insofar as one's acquired habits are heading towards and fulfilling a very precise function within the social mediation of the good.” Without habits, specializations and coordinated human operations would not be possible. With respect to acquiring skills, Lonergan emphasizes the importance of the self-correcting process of learning. He writes, “One gets an insight, one catches onto something, and then finds that it is not quite the whole

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694 *Early Works on Theological Method I*, 36.
695 *Topics in Education*, 55.
696 Ibid., 39.
697 *Early Works on Theological Method I*, 36.
698 Ibid., 35.
700 Ibid.
701 *Early Works on Theological Method I*, 38.
702 *Topics in Education*, 35.
story, and catches on to something more, and gradually builds up a whole circle of insights that yield a certain mastery of the situation.” Strictly speaking, Lonergan considers a skill to be a type of habit, a certain dexterity by which one does not have to learn how to do something.

The enormous array of habits and skills that human beings are capable of developing can potentially be the very ones that are demanded by socially mediated institutional roles and tasks. Operations become cooperations “inasmuch as members assume roles and perform tasks within institutional frameworks, that is, already understood and commonly accepted manners of cooperating.” Examples of institutions include the family, education, the state, the law, the economy, and technology. An institution should not be conceived as a building. Instead, it is “a set of insights, skills, habits, and feelings oriented to the continuous flow of particular things that people want.” One could argue that an institution is the product or expression of human cooperation. Matthew Lamb likens institutions to languages in the sense that they “are not fixed and immutable entities, but change as the ways in which the modes of human cooperation constituting them change.” As Lonergan notes, “The family, the state, the law, the economy are not fixed and immutable entities. They adapt to changing

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703 Early Works on Theological Method I, 38.
704 Topics in Education, 35.
705 Method in Theology, 48. Lonergan claims that institutions are like habits, but in the objective order. He defines an institution as “a mechanism set up for making decisions.” Please see: Topics in Education, 35-36.
707 Early Works on Theological Method I, 37.
708 Tad Dunne, Lonergan and Spirituality: Towards a Spiritual Integration (Chicago: Loyola University, 1985), 86.
710 Ibid.
circumstances, they can reconceived in the light of new ideas, they can be subjected to revolutionary change.”

The end or object of the development of skills and habits, as well as the fulfillment of institutional roles and the carrying out of institutional tasks, is the good of order. In *Insight*, Lonergan calls the good of order “a new notion of the good” or “a second meaning of the good,” one that is not reducible to the mere presence of particular goods. Although the “regular recurrence of particular goods is a fundamental aspect of the good of order,” the good of order is distinct from that regular recurrence. To be sure, the good of order “is what gives rise to the constant, regular, rhythmic occurrence of the particular goods” and it is indeed “an indispensable constituent of human living.” However, the mere production of particular goods “is an instance in which there can be or may not be realized a good of order.” Paul Hoyt-O’Connor brings out this point very well:

While particular goods may satisfy some human want or need, the regular and recurrent enjoyment and the ordering of human action are themselves distinctly valuable. For the attainment of particular goods time and time again is conditioned by the cooperation of any number of individuals, and breakdowns in this framework spell that the enjoyment of these goods will be at best precarious and sporadic. Thus the intelligibility and choice-worthiness of goods of order are distinct from and not reducible to instances of particular goods.

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712 Early Works on Theological Method I, 35; Method in Theology, 48.
713 Insight, 238.
714 Ibid., 619.
715 Topics in Education, 35.
716 Method in Theology, 49.
717 Early Works on Theological Method I, 36.
718 Insight, 239.
Particular goods are event-conditioned things in the sense that they would not be available unless certain preceding events occurred.\(^{721}\) As Tad Dunne observes, “[T]here has to be some setup, some routine, some institution, some scheme of recurrence that brings forth a certain kind of particular good *regularly.*”\(^{722}\) This setup is not the particular goods themselves, but rather the good of order: \(^{723}\) a complex, interdependent, dynamic, and intelligible pattern of human relationships, which consists of the parceling out of tasks, roles, and responsibilities, for the sake of providing instances of the particular good for individuals.

Kenneth Melchin helpfully articulates why the good of order is not reducible to instances of the particular good by calling attention to the nature of the obligations that institutionalized patterns of cooperation impose upon people. Melchin writes:

> What is striking about the patterns of cooperation of a family, a business, an economy, or a police force is that often they give rise to obligations that are not themselves objects of personal desire… *The meaning and value of these obligations lies in their contribution to an overall pattern that coordinates the diverse contributions of all into a functioning whole.* The pattern is not in the first instance an object of desire or need; it is an intelligible order that must be understood.\(^{724}\)

Part of what characterizes the good of order is the underlying order that sustains the succession of recurring instances of types of the particular good.\(^{725}\) The concrete “goodness” of the good of order, then, simply cannot be equated with mere instances of the particular good.

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\(^{721}\) Tad Dunne, *Lonergan and Spirituality: Towards a Spiritual Integration*, 85.

\(^{722}\) Ibid.

\(^{723}\) Ibid. Please see also: *Topics in Education*, 34.


\(^{725}\) *Method in Theology*, 49.
The good of order is also not tantamount to institutions. As opposed to equating the good of order with institutions, Lonergan finds it more helpful to accentuate the actual functioning or malfunctioning of institutions in his discussion of the good of order. The institution of the family, for instance, can produce “bliss in one case and misery in another.” Another example that Lonergan provides is the great Depression of the 1930’s. Institutions like the government, along with natural resources, willing workers, and entrepreneurs were all present at the time, but the good of order was severely defective. The important point is that “[t]he desires and effective decisions that bring about particular goods do not explain their number and distribution at any point in time, and whether the flows of goods are trickles or torrents depends upon actually functioning institutions.” What constitutes institutional breakdowns like marital discord, political decay, and economic breakdown is not the presence or absence of any particular good, or even necessarily the presence or absence of a given institution. Rather, those institutional disturbances “are the breakdown and decay of the good of order.” Precisely how and how well human beings go about satisfying their needs in relationship to how and how well they contribute to satisfying the needs of other people is essentially what the good of order is all about.

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726 *Early Works on Theological Method I*, 37.
727 Ibid.
729 Ibid.
730 *Early Works on Theological Method I*, 36.
732 *Insight*, 239. Italics mine.
The good of order, then, is not an institution, though it has its basis in institutions.\textsuperscript{733} It is the product of “all of the skill and know-how, all the industry and resourcefulness, all the ambition and fellow-feeling of a whole people, adapting to each change of circumstance, meeting each new emergency, struggling against every tendency to disorder.”\textsuperscript{734} The good of order exists to the extent that a large set of roles and tasks are ordered, and it does not exist to the extent that those activities fail to be ordered.\textsuperscript{735} Lonergan affirms, “If X is a good thing and occurs, it will recur when there is a good of order.”\textsuperscript{736}

Nor is the good of order some unrealized ideal, something “that ought to be but is not.”\textsuperscript{737} It is not “some entity dwelling apart from human actions and attainments.”\textsuperscript{738} The good of order is not what the economist thinks that it is, “but what the economist is approximately trying to get to know.”\textsuperscript{739} Furthermore, the good of order is “not some design for utopia, some theoretic ideal, some set of ethical precepts, some code of laws, or some super-institutions.”\textsuperscript{740} Instead, it is the concrete and actually functioning way that cooperation is working out within institutions.\textsuperscript{741} Lonergan is quick to point out that the concrete and actually functioning way that cooperation within institutions is working out is endlessly complex and manifests itself in different ways.\textsuperscript{742} In economics, for example, the key facet of the good of order is interdependence, while in politics it is “preventing

\textsuperscript{733} Method in Theology, 49.
\textsuperscript{734} Ibid., 49-50.
\textsuperscript{735} Tad Dunne, Lonergan and Spirituality: Towards a Spiritual Integration, 86.
\textsuperscript{736} Topics in Education, 34.
\textsuperscript{737} Insight, 238.
\textsuperscript{738} Ibid.
\textsuperscript{739} Early Works on Theological Method I, 37.
\textsuperscript{740} Method in Theology, 49.
\textsuperscript{741} Ibid.
\textsuperscript{742} Early Works on Theological Method I, 603.
evils, protecting people, [and] securing their liberties and rights.” The elimination of breakdowns in the good of order “takes all the knowhow and all the generosity of everyone in the group to make things run well.”

A potentially fruitful way to conceive of the good of order is to liken it to an ecosystem or ecology, or what Lonergan calls “an assembly of assemblies of schemes of recurrence.” The good of order is characterized by a complex interdependence between schemes of recurrence that support one another. Lower, subordinate schemes of recurrence underpin higher orders of schemes and higher schemes of recurrence “bring to fuller fruition their subordinates.” In his *Macroeconomic Dynamics: An Essay in Circulation Analysis*, Lonergan discusses how the economy is characterized by “the myriad interlocking recurrences of activities within and between firms, between firms and households, and within households.” Each one of those interlocking schemes of recurrence “is a possibility that occurred to someone at some point of ancient or recent human history, that has been combined with other schemes in proposed possibilities, that has been chosen with greater or lesser probability and maintained with greater or less deliberate choice.” As for those existing sets of combinations of schemes of recurrence, Lonergan argues that they have “functioned with greater or less success for a

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743 Ibid.
745 Ibid.
748 Ibid.
749 Ibid.
750 Ibid.
longer or shorter period of time.” An economy, in brief, “is just part of ongoing human history.”

Unsurprisingly, to understand the good of order, one “must shift from a common-sense patterning of knowing into a theoretical perspective.” The good of order is an invisible, “formal intelligibility that is to be discovered only by raising questions, grasped only through accumulating insights, formulated only in conceptions.” It is dynamic, a system on the move, rather than the static culmination of mechanist planning. Lonergan notes that it “consists in an intelligible pattern of relationships that condition the fulfilment of each man’s desires by his contributions to the fulfilments of the desires of others, and similarly protect each from the object of his fears in the measure he contributes to warding off the objects feared by others.” The good of order “lies totally outside the field of sensitive appetition” and is grasped by human intelligence.

Significantly, like human history, the good of order “does not develop in the glorious fashion” of intellectual development, rather it tends to develop “under a bias in favor of the powerful, the rich, or the most numerous class.” Still, the good of order “possesses its own normative line of development, inasmuch as elements of the idea of order are grasped by insight into concrete situations, are formulated in proposals, are

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751 Ibid.
752 Ibid.
755 *Insight*, 621.
756 Ibid., 620.
757 *Topics in Education*, 34.
758 *Insight*, 238.
759 Ibid., 621.
760 Ibid., 624.
761 *Topics in Education*, 60.
accepted by explicit or tacit agreements, and are put into execution only to change the situation and give rise to still further insights.”\textsuperscript{762} The good of order is, therefore, amenable to the insights yielded by the self-correcting process of learning, but by no means inevitably the product of that process.

The fact that no single good of order, nor any institution or set of institutions, are the only ones possible prompts Lonergan to shift his attention from the second level of the human good to the third.\textsuperscript{763} As Lonergan writes, “The existence of a manifold of possibilities for the good of order and the institutions that underpin them gives rise to, reveals, and brings to light the notion of value.”\textsuperscript{764} It is by way of “appealing to value or values that we satisfy some appetites and do not satisfy others, that we approve some systems for achieving the good of order and disapprove of others.”\textsuperscript{765} When human beings are reflective and rational, particular goods, institutions, and goods of order are inevitably bound to be considered, evaluated, and criticized.\textsuperscript{766} Lonergan affirms, “The particular good leads man into the good of order, the good of order leads man into reflecting on the order and evaluating it and criticizing it. In that evaluation and criticism there emerges the notion of value, Is it worthwhile?”\textsuperscript{767} For instance, the Cold War had its basis in the fact that people in the West had “a different idea of the good of order from that of the Soviets.”\textsuperscript{768}

\textsuperscript{762} \textit{Insight}, 620.
\textsuperscript{763} \textit{Early Works on Theological Method I}, 38.
\textsuperscript{764} Ibid., 39.
\textsuperscript{765} Ibid., “The Subject,” 81-82.
\textsuperscript{766} \textit{Topics in Education}, 39.
\textsuperscript{767} Ibid., 40.
\textsuperscript{768} Ibid., 37.
The potency on the third level is liberty, effective freedom, or self-determination. Liberty is experienced as “the active thrust of the subject terminating the process of deliberation by settling on one of the possible courses of action and proceeding to execute it.” Lonergan argues that knowledge does not, of itself, settle a course of action. Rather, knowledge “grounds different possible courses of action.” Lonergan approvingly cites Jean-Paul Sartre’s “experiment of liberty” as a way of establishing “the fact of freedom.” Sartre’s experiment of liberty involves posing the question to oneself, “Have you been in the torture chamber with the Nazis and refrained from giving your comrades away?” One will know what freedom means if one went through that experience and refrained from turning one’s friends over to the Nazis. By freedom, Lonergan means, “Man can do this or that; he can do this or not do it. He can do good or evil.” For Lonergan, “man is not only a center of capacities and needs, a center of perfectibility, he is a free center.”

The first of two actuations on the third level is orientation, by Lonergan means “the direction of the flow of a person’s consciousness.” The trajectory of this direction heavily depends upon one’s use of liberty or freedom. Lonergan writes:

Human consciousness is not a fully determined function of sensitive

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769 Method in Theology, 48.
771 Method in Theology, 50.
772 Ibid.
773 Understanding and Being, 227.
775 Ibid.
776 Ibid.
777 Early Works on Theological Method I, 301.
778 Ibid. 302.
780 Early Works on Theological Method I, 39.
impressions and hereditary equipment. *Consciousness also depends upon an orientation within the subject that is accepted and willed by the subject.* There is such a thing as freedom of consciousness – principally, of course, in the sense that acts of will are free, but also and by way of a precondition in the sense that consciousness itself is not something determined uniquely by external objects or internal objects, by biological or sensitive conditions and determinants.⁷⁸¹

One’s consciousness “floats” according to the freely willed orientation of the subject.⁷⁸²

What one happens to be conscious of at any given moment depends much more upon one’s horizon of interests and concerns than upon the presence of things to which one can attend.⁷⁸³

With respect to one’s orientation, liberty can be exercised either horizontally or vertically. Paul Hoyt-O’Connor brings out the distinction between the two exercises of liberty by writing, “Horizontal exercises of liberty are made within some determinate horizon and on the basis of one’s guiding concerns. Vertical exercises of liberty, on the other hand, are decisions about one’s horizon and the orientation of one’s being.”⁷⁸⁴

Horizontal exercises of liberty occur within the horizon that one has already attained and contribute to what Lonergan calls a horizontal development.⁷⁸⁵ Vertical development, on the other hand, takes place “when one has moved beyond one’s present horizon, when someone pulls the rug from underneath your world and you have to move into another world.”⁷⁸⁶ In other words, vertical development is fundamentally about conversion, the second actuation on the third level in the structure of the human good.

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⁷⁸¹ *Topics in Education*, 62-63. Italics mine.
⁷⁸² Ibid., 63.
⁷⁸⁶ Ibid.
In *Method in Theology*, Lonergan writes, “As orientation is, so to speak, the
direction of development, so conversion is a change of direction and, indeed, a change for
the better.” Conversion, on this third level, is “from a self-regarding to a self-
transcending orientation.” This powerful experience is vividly described by Lonergan:

One frees oneself from the unauthentic. One grows in authenticity.
Harmful, dangerous, misleading satisfactions are dropped. Fears of
discomfort, pain, privation, have less power to deflect one from one’s
course. Values are apprehended where before they were overlooked.
Scales of preference shift. Errors, rationalizations, ideologies fall and
shatter to leave open to things as they are and to man as he should be.

By becoming an existential subject that transcends oneself, one becomes an originating
value. Originating values are “authentic persons achieving self-transcendence by their
good choices.” What the self-transcending, authentic subject decides to do, as an
originating value, is what Lonergan calls terminal value: “true instances of the
particular good, a true good of order, a true scale of preferences regarding values and
satisfactions.”

Since one’s conversion “regards the very direction of one’s conscious life,”
becoming an originating value that chooses terminal values is a personal event.
Nevertheless, it is not entirely a private event. Originating values are “the foundations
of a transformed social order.” As Paul Hoyt-O’Connor writes, “The principles of
human progress are precisely these originating values who faithfully adhere to the

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787 *Method in Theology*, 52.
789 *Method in Theology*, 52.
790 *Early Works on Theological Method I*, 617.
791 *Method in Theology*, 51.
793 *Method in Theology*, 51.
795 *Method in Theology*, 269.
immanent laws of conscious intentionality and who are effectively free to know and do the good.” 797 Human progress “proceeds from originating value, from subjects being their true selves by observing the transcendental precepts, Be attentive, Be intelligent, Be reasonable, Be responsible.” 798 When the social process is marked by progress, “the mistakes of the past are eliminated to some extent, and intelligence is effectively guiding another part or aspect of the social process.” 799 New and fresh insights reveal and bring to light past oversights, while generating creative solutions and possible salubrious courses of action.

Individual liberty is not exercised in a vacuum. The social mediation on the third level is personal relations, 800 which Lonergan, in Insight, affirms have a “singular importance in human living.” 801 Personal relations rest upon institutional roles and tasks. 802 Lonergan declares, “Institutional roles and tasks set up personal relations of all sorts, with all the people you meet from morning to night.” 803 The extent of an individual’s self-regarding or self-transcending orientation is revealed by the way in which one participates in these relations. As Fred Lawrence observes, “On Lonergan’s analysis of the structure of the human good, the orientation of people is shown in the personal relations implicit in their cooperation for the sake of particular goods, and in the roles they play and the tasks they fulfill in the different institutional orders of familial, educational, technological, economic, legal, political, artistic, and religious schemes of

797 Ibid.
798 Method in Theology, 53.
800 Method in Theology, 48.
801 Insight, 754, note 1.
803 Ibid.
recurrence in society.”

Lonergan goes so far as to say, “Through personal relations there is a concrete, immediate apprehension of what the good of order concretely is... [T]he simplest and most effective apprehension of the good of order is in the apprehension of personal relations.”

Personal relations are typically alive with feeling, as individuals relate to one another “by the commitments that they have freely undertaken and by the expectations aroused in others by the commitments, by the roles they have assumed and by the tasks that they meet to perform.” The quality of personal relations can “vary from intimacy to ignorance, from love to exploitation, from respect to contempt, from friendliness to enmity.” Personal relations have the potential to bind a community together or to tear it apart.

Lonergan does not conceive of a community as a group of people sharing a common zip code. Community is, instead, a matter of common experiences, sharing a common understanding, sharing common judgments, and arriving at a common consent on values and goals. Devoid of these common elements, individuals lose touch with one another, misunderstand and distrust each other, live in different worlds, and work at cross-purposes. For this reason, Lonergan makes a distinction between a community, in which those common elements are present, and a mere society. Within the confines of a community, Lonergan notes, “It is here where man’s freedom reaches its high point,

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805 Topics in Education, 41.
806 Method in Theology, 50.
807 Ibid., 51.
808 Ibid.
810 Ibid. Please see also: Method in Theology, 356-357.
811 Method in Theology, 360.
here that his responsibility is greatest, here that there emerges the existential subject who discovers for himself that he has to decide for himself what he is to make of himself.”812 Genuine and sustained human progress is dependent upon “attentive, intelligent, reasonable, and responsible cooperation in ever expanding and complementary networks of community,” while the “repression of such cooperation and community” is the key to decline.813 In the chapters that follow, especially the ones centering on various parties involved in the subprime mortgage crisis, one will encounter a devastating lack of community.

1.12. Conclusion

In this chapter, I have examined a key set of theoretical tools that will help cast light on the contributing factors and causes of the subprime mortgage crisis in the chapters that follow. Lonergan’s profound understanding of what it means to be authentically human, a self-verifiable enterprise that is of paramount importance, yet subject to false-starts, challenges, setbacks, and failures, coupled with his penetrating account of human history, can serve as a template for understanding why the subprime mortgage crisis came into being. Human beings shape human history by the quality of their decisions and actions. The quality of their decisions and actions depends upon their antecedent judgments of value, deliberations, evaluations, and judgments of fact. Arriving at sound judgments of fact, which are, so to speak, the raw materials for evaluating, deliberating, and value judging, require prior and demanding cognitional work, including the grasping of reflective insights, marshaling and weighing the

evidence, earnestly posing “Is it so?” questions, formulating direct insights, and
creatively and persistently seeking answers to questions for understanding. Sufficient
answers to questions for understanding, made possible by grasping direct insights,
depend upon the raising of the questions themselves. The act of inquiring requires that
individuals diligently attend to and wonder about their sensible experiences. Individuals
must also keep vigilant watch over the quality of their feelings - and how those feelings
may be shaping one’s horizon: the boundary in which one’s cognitional and volitional
work takes place. A continuous flow of improvements, which Lonergan calls progress, is
possible if individuals adhere to the transcendental precepts: Be attentive, Be intelligent,
Be reasonable, Be responsible.814

But human beings are subject to bias, and so human history is vulnerable to
decline. The transcendental precepts can be violated and evaluations “may be biased by
an egoistic disregard of others, by a loyalty to one’s own group matched by a hostility to
other groups, by concentrating on short-term benefits and overlooking long-term
costs.”815 All of those biases are prevalent in the chapters that follow. Regulators and
regulated alike, in varying degrees and different ways, succumbed to bias, which over
time introduced a dysfunctional and pernicious element into the good of order. Chapter
two will provide a general sketch of this argument, while the remaining chapters (three
through six) will examine it in closer detail.

814 Method in Theology, 53.
815 Ibid.
Chapter Two

2.0. A Bridge from Theory to the Subprime Mortgage Crisis

2.1. Introduction

Perhaps the smoothest transition into an analysis of the subprime mortgage crisis is to consider the role that general bias played in inciting it. Leading up to the subprime mortgage crisis, common sense indicated that house prices would inevitably continue to rise. Common sense also grasped that when house prices continually rise, money can be made from mortgages that were historically considered below-prime. Under these conditions, seemingly all parties involved had something to gain (Figure 1, below): (1) borrowers were approved to live in houses that they would otherwise be unable to afford; (2) lenders received origination fees from these borrowers; (3) lenders also received fees from arrangers for originating mortgage loans, regardless of whether the loan applications accurately reflected the borrower’s credit risk or not; (4) arrangers securitized those mortgages and the credit rating agencies, for a fee, inflated their ratings of these products; (5) AIG was happy to sell, for a fee, excessive credit protection on subprime-related securities; (6) arrangers issued, for a fee, those highly rated securities to institutional investors; (7) even Fannie Mae and Freddie Mac, the stalwarts of the secondary mortgage market who specialized in prime, conforming mortgages, purchased subprime mortgages from lenders for a fee; (8) Fannie Mae and Freddie Mac securitized those mortgages and offered them to investors, and guaranteed, for a fee, that borrowers would timely meet their mortgage obligations.816 All eight of these group interests spawned group biases

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816 Of course, Fannie Mae and Freddie Mac could also retain those securities in their own portfolios, which was a profitable venture in the short run.
which reinforced the general bias about the unmitigated rise in house prices. In other words, group and general biases combined to block serious pursuit of questions about really long-term trends in house prices.

**Figure 1.**

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I will argue in this and later chapters that, with so much money to be made, group bias easily found a home in various institutional relationships. Federal regulators could justify standing out of the way of their regulated institutions. Other institutions could compromise the quality of the particular goods that they produced for the community in the interest of the particular good of profits for themselves. Over time, a dramatic breakdown in the good of order occurred as the biased decisions among individuals accumulated and created a distorted social situation. Millions of Americans lost – or are still in danger of losing – their homes and accumulated equity. Institutions that had flourished for decades collapsed in months. This partial breakdown of the good of order will be discussed, in detail, in chapters three through six.

In order to more effectively examine this deterioration of the good of order, there are a few pertinent peripheral issues that will be explored in this chapter as well. In section 2.5, the absence of a federally established and recognized definition of the term “subprime” created a barrier to effective regulation, for how can one regulate something without an account of what that thing is? In section 2.6, I will briefly explain the important difference between the primary and secondary market. In section 2.7, I will examine some of the key deregulatory preconditions that contributed to the emergence of the subprime mortgage market. My discussion of the Savings and Loan Crisis of the 1980’s, which should have underscored the importance of soundly regulating mortgage lenders in the future, illustrates the power of general bias. As Bob Ivry and Jonathan Keehner noted in a *Bloomberg News* article, the Savings and Loan crisis, like the subprime mortgage crisis, was triggered by poor real-estate bets and resulted in the
government creating “a tax-payer funded enterprise to absorb the fallout” from those bets. Commonsense practices of many business and political actors in the 1990’s and 2000’s, however, suggest that there was a failure to achieve an adequate grasp of the risks associated with financing homes in a deregulatory environment, such as the one present in the 1980’s. The original subprime crisis, occurring in the late 1990’s and explored in section 2.8, further substantiates this claim. Far from serving as a warning about the volatility and risks associated with subprime mortgages, this crisis was a distant memory by the turn of the century.

2.2. A First Approximation of General Bias’ Role in the Subprime Mortgage Crisis

In an April 2012 paper, two senior economists at the Federal Reserve Bank of Boston and one research economist at the Federal Reserve Bank of Atlanta argue that overly optimistic beliefs about house prices were at the center of the subprime mortgage crisis. The authors instructively label this phenomenon “bubble fever” that infected borrowers, lenders, arrangers, the credit rating agencies, and investors alike. Leading up to the subprime mortgage crisis, it was common sense that house prices in the United States never go down. As the authors write, “Zero-down loans, subprime mortgages, negative amortization, and reduced documentation all make sense if prices are expected

820 Ibid.
to grow rapidly, since it is the value of the house - not the borrower’s income - that guarantees repayment of the loan.\textsuperscript{821}

When the value of one’s house goes up, one’s loan-to-value ratio drops, typically making one more eligible to refinance. Or, alternately, one could potentially be a position to attempt to sell the home for a profit. In either case, under the assumption that house prices will inevitably rise, lenders came to expect that there was a high likelihood that borrowers would be able to “repay” their loans by way of refinancing or selling their homes.\textsuperscript{822} From the perspective of a borrower, mortgages that required one to put little or no money down offered the opportunity to buy a house with little risk. If the price of one’s house rose, one could sell at a profit. In the event that house prices dropped and one could no longer afford the monthly mortgage payment, one could walk away with minimal out-of-pocket expenses. With such an attractive upside and a tolerable downside, conditions were fertile for borrowers to fail to take seriously the further pertinent questions that could have, and indeed should have, emerged as they were deliberating over whether it was worthwhile to purchase a given house.

The counterposition that house prices will perpetually rise, in other words, interfered with a borrower’s ability to deliberate over the question of value, “How much should I save for my house down payment?” As articulated in a popular home buying book, \textit{Insider Secrets to Home-Buying Success}, which was published in July of 2007, this is a central question of value for a home buyer.\textsuperscript{823} With house prices perceived to be continually rising, the authors highlight how “valuable time is ticking away” for

\begin{flushright}
\textsuperscript{821} Ibid., 33.
\textsuperscript{822} Ibid., 7.
\textsuperscript{823} Joseph M. Farella and Earl Myers, \textit{Insider Secrets to Home-Buying Success} (Lincoln: iUniverse Books, 2007), 16. The authors, of course, do not use the terminology “question of value,” but they present a chart with the heading, in bold, “Should I Wait for a Down Payment?”
\end{flushright}
borrowers as they attempt to save for their down payment, which could result in house prices and interest rates rising to unaffordable levels.\textsuperscript{824} This undesirable scenario, the two authors note, “could leave you with an even larger monthly payment” than if you would have put less than 20% down sooner.\textsuperscript{825} The authors use the twelve month period ending in June of 2005 to substantiate their point. With real estate appreciating between 8% to 20% during those twelve months and salaries only increasing an average of 3.3% over that same period of time, the authors point out that the price of a $300,000 house could go up another $60,000 - $100,000 over the next five years. The authors tell us, “The little Cape Cod that would have cost you $300,000 will now cost $400,000 – and that’s a very conservative estimate.”\textsuperscript{826} Not only would one be unable to purchase one’s dream house by waiting five years to save for a 20% down payment, additionally one “will have missed out on the appreciation of the housing market.”\textsuperscript{827}

I would like to note in passing the possible feelings that could have arisen in such a home buying climate. First, there is the fear of missing out on the opportunity to buy one’s dream home should one save for a 20% down payment. Then, there is the fear of being permanently priced out of the sort of housing one would like to live in. Finally, there is the anticipated pain of losing out on the capital gains earned by purchasing one’s dream home, miniscule down payment and all. The authors write, “Despite the routine and historically predictable market fluctuations, real estate continues to appreciate each year. So what if the increase is only 8% next year instead of 20%? If you purchased a home today, it would still represent a major appreciation and wise investment of your

\textsuperscript{824} Ibid.
\textsuperscript{825} Ibid.
\textsuperscript{826} Ibid., 17.
\textsuperscript{827} Ibid.
funds." All of these feelings, I propose, would be intentional responses to disagreeable alternatives.

Investors, for their part, also suffered from mistaken house price expectations according to the “bubble fever” thesis. As the authors of the paper note, “[I]f investors think that house prices can rise 11 percent per year, expected losses [on their investments] are minimal.” Gretchen Morgenson nicely captures the spirit of many investors of subprime-related securities leading up to the crisis. She writes, “It’s amazing how long it can take investors to see that the wheels are coming off a prized investment vehicle. Denial, after all, is a powerful thing. But when an imperiled favorite happens to be a pool of asset-backed securities - especially those involving home mortgages - denial can be compounded by outright blindness to the real risks of that investment.” Morgenson argues that investors “flocked to the mortgage-backed market” because they were “chasing the buzz of higher yields.” Once again, the counterposition of endlessly rising house prices lodged itself into a decision-making horizon, this time in the sense that subprime-related investments were portrayed as having huge upsides with little risk of any downsides.

One of the most important questions pertaining to the responsibility of subprime investors was the extent to which they understood the risks associated with the products in which they were investing. As Dan Fitzpatrick, writing for The Wall Street Journal, noticed, “Much of the postmortem debate and legal fights following the financial crisis

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831 Ibid.
come down to the question of investor sophistication. Investors say the financial products were so complex that they should never have been offered to individuals not savvy enough to understand them. Banks routinely say buyers burned by these deals were sophisticated enough to know the risks.\textsuperscript{832} The technical definition of a “sophisticated investor,” according to the Securities Act of 1933, is one who “has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment.”\textsuperscript{833} A key benchmark for assessing whether an investor is sophisticated, according to the SEC, is whether one is an “accredited” investor. An accredited investor “must have a net worth of $1 million, an annual income of $200,000 or control a trust with assets of $5 million.”\textsuperscript{834} Whether or not this is an adequate definition of investor sophistication is debatable. Yet it is clear that a great many who invested in subprime securities either directly or indirectly did not satisfy even this minimal definition.

Currently, perhaps the most combative issue centers on the transparency of the risks contained in previously issued collateralized debt obligations (CDOs). In May of 2005, then-Federal Reserve Chairman Alan Greenspan “noted the complexity of collateralized debt obligations and the challenges they pose to ‘even the most sophisticated market participants’.”\textsuperscript{835} According to some accounts, supposedly sophisticated investors were not sophisticated enough to understand subprime CDO’s, so in lieu of conducting their own due diligence reviews they carelessly relied on the ratings

\textsuperscript{832} Dan Fitzpatrick, “Irked Investors Target Merrill --- Wall Street Firm Defends CDO Disclosures; Clients Say the Risks Weren’t Clear,” \textit{The Wall Street Journal} (June 11, 2010).
\textsuperscript{833} Ibid.
\textsuperscript{834} Ibid.
\textsuperscript{835} Gretchen Morgenson, “Will Other Mortgage Dominos Fall?”
of the credit rating agencies. The key point, however, is that the general bias of common sense gave investors in subprime-related products the “luxury” of being able to bypass conducting their own due diligence reviews because under the assumption that house prices would only go up, the risks of these products vanishes. Further pertinent questions were dismissed as not being pertinent when one is deliberating over whether one should invest in a given subprime-related security.

Additionally, one could argue that the arrangers, Fannie Mae and Freddie Mac, and AIG were blinded by the general bias of common sense. Since several arrangers, including Merrill Lynch, Bear Stearns, and Morgan Stanley, were among those that suffered the heaviest subprime-related losses, the authors claim that they, too, were swept away by the delusion that house prices would unceasingly rise. The authors rightly note that the arrangers were typically the ones that were “most closely associated with the origination and securitization of mortgages.” Rather than using this knowledge to ultimately pocket the most money or at least incur the smallest losses among the participants in the subprime mortgage market, however, many of these arrangers chose to hold onto these securitized subprime-related products and endured incredible losses. Many of the arrangers that resisted the allure of the counterposition of continually rising house prices still fell victim to the general bias of common sense because they reluctantly entered the subprime market out of a panicked desire to remain competitive. I believe that Lonergan would classify this as an instance of the longer cycle of decline:

836 Please see, for example: David Faber, And Then the Roof Caved In: How Wall Street’s Greed and Stupidity Brought Capitalism to Its Knees (Hoboken: Wiley, 2009), 102; 165.
838 Ibid., 18.
839 Ibid. Goldman Sachs is arguably an exception.
Such is the dialectic of decline. Spontaneously it keeps making things ever worse. But reflection gives it the seven devils worse than itself. For it gives evil the status of fact. That is the way that things are, the way that things are done, the only way that one can live, indeed the way that all successful and respectable people live. One can swim against the current for a while but sooner or later one gives up.\(^{840}\)

I will argue in the section on the two housing GSEs, Fannie Mae and Freddie Mac (Chapter 6) that they, too, succumbed to the counterposition of endlessly rising housing prices. As long as home prices were going up, they could continue to perform their unsustainable juggling act of balancing the demands of a congressionally chartered mission with the fiduciary duty to maximize returns to shareholders with little regard for long-term consequences. Though this juggling act was unsustainable in the long-term, it was able profitable in the short-term. The insurance giant, AIG, was likewise blinded by general bias, as its financial products unit sold far more credit protection on subprime-related products than it could ever hope to cover, should house prices decline and the value of those products drop.

Jack Guttentag, a Professor Emeritus of Finance at the University of Pennsylvania, offers a thesis that resembles the “bubble fever” thesis, which he calls “disaster myopia.” In short, the disaster myopia thesis involves “basing mortgage prices and underwriting rules on the assumption that because house prices had risen for a long period, they would continue to rise.”\(^{841}\) Due to the fact that house prices never declined year-after-year nationwide until July of 2006,\(^{842}\) all of the parties involved in the crisis were carried away by the belief that those prices would never decline, or at least would

\(^{840}\) *Macroeconomic Dynamics: An Essay in Circulation Analysis*, 94.


not decline in the foreseeable future. Guttentag argues that the subprime lenders were especially seduced by this mistaken expectation because they stood to make large sums of money in a very short time as long as house prices increased.  

It is evident that bubble fever or disaster myopia or general bias infected other institutions as well. On July 1, 2005, approximately one year before house prices peaked, and six months before he was nominated as the Chairman of the Federal Reserve, Ben Bernanke had the following exchange with an interviewer on CNBC:

Interviewer: Tell me, what is the worst-case scenario? We have so many economists coming on our air saying ‘Oh, this is a bubble, and it’s going to burst, and this is going to be a real issue for the economy.’ Some say it could even cause a recession at some point. What is the worst-case scenario if in fact we were to see prices come down substantially across the country?

Ben Bernanke: Well, I guess I don’t buy your premise. It’s a pretty unlikely possibility. We’ve never had a decline in house prices on a nationwide basis. So, what I think is more likely is that house prices will slow, maybe stabilize, might slow consumption spending a bit. I don’t think it’s going to drive the economy too far from its full employment path, though.  

Former Chairman of the Federal Reserve, Alan Greenspan, ended up acknowledging that the Federal Reserve, no less, failed to grasp the magnitude of the housing bubble. Greenspan proclaimed, “Given history, we believed that any declines in home prices would be gradual.” The history that Greenspan was referring to was the stock market crash of 1987 and the dot-com crash in the early part of 2000. He noted that since those crashes resulted in “only modestly negative economic aftermaths” the Fed ended up

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843 Jack Guttentag, “Shortsighted About the Subprime Disaster.”
being “lulled into a sense of complacency.”\textsuperscript{846} Able to weather those two storms reasonably well, Greenspan asserted that the Fed did not believe that “[d]establizing debt problems” would arise due to a housing bubble.\textsuperscript{847} Indeed, about fourteen months before house prices declined, on May 20, 2005, Greenspan publicly professed that he saw no sign of a nationwide housing bubble, though he expressed concern over potential pockets of “froth” or local housing bubbles.\textsuperscript{848} In March of 2010, Greenspan conceded, “We all misjudged the risks involved. Everybody missed it – academia, the Federal Reserve, all regulators.”\textsuperscript{849}

In the previous chapter, it was noted that counterpositions are singularly resistant to reversals that can be achieved in a single stroke. The counterposition of perpetually rising house prices is no exception. Aside from the enormous issue of how this counterposition can serve as a basis for engaging in operations that are profitable in the short-term,\textsuperscript{850} it also blends in very well with the American Dream of homeownership.\textsuperscript{851} I will argue in chapter six that Fannie Mae and Freddie Mac resisted regulation of risky, though profitable activities by appealing to, among other things, the American Dream.

The climate of this unreasonable expectation of perpetually rising house prices took place during a time in which homeownership in America was flourishing. On June 20, 2000, the United States Senate Committee on Banking, Housing, and Urban Affairs

\textsuperscript{846} Ibid.
\textsuperscript{847} Ibid.
\textsuperscript{850} These operations will be identified in the sections on the different parties involved in the subprime mortgage crisis, most notably the lenders, the arrangers, Fannie Mae and Freddie Mac, and the credit rating agencies.
\textsuperscript{851} Depending upon how one conceives of this dream, it can potentially be a counterposition itself. Arguably, there has occurred a delicate shift from the dream of homeownership as something that one earns, to the dream of homeownership that one deserves.
held a hearing to examine proposals to promote affordable housing. At the time of the hearing, 70.7 million Americans owned a home, more than any other time in United States history.\textsuperscript{852} Despite this unprecedented growth, the general tenor of the hearing was that much more could be done to make housing more affordable.

For example, Frank Thompson, testifying on behalf of The National Association of Home Builders, noted that certain age groups were well “below their peak homeownership rates of the late 1970s and early 1980s.”\textsuperscript{853} He proceeded to declare, “When American families are denied the opportunity to purchase a home, the whole nation suffers. Homeownership is the cornerstone of family security, stability, and prosperity. It strengthens the nation by encouraging civic participation and involvement in schools and communities.”\textsuperscript{854} Cathy Whatley, testifying on behalf of The National Association of Realtors, proclaimed that her organization had a “commitment to assure that every American has the opportunity to attain a decent, safe and affordable home.”\textsuperscript{855} She went on to argue that this commitment had to be addressed “at the highest level of national priorities and must include the complete spectrum of the housing ladder - from the homeless to the first-time homebuyer.”\textsuperscript{856} Homeownership, she maintained, “should be viewed as a series or ladder of opportunities - the first few rungs represented as steps through rental housing, the middle rungs representing first-time homebuyers, and the

\textsuperscript{852} William Apgar, “Testimony Before the United States Senate Committee on Banking, Housing, and Urban Affairs, Subcommittee on Housing and Transportation,” (June 20, 2000), available at http://banking.senate.gov/00_06hr062000/apgar.htm.
\textsuperscript{853} Frank C. Thompson, “Testimony Before the United States Senate Committee on Banking, Housing, and Urban Affairs, Subcommittee on Housing and Transportation,” (June 20, 2000), available at http://banking.senate.gov/00_06hr062000/thompson.htm.
\textsuperscript{854} Ibid.
\textsuperscript{855} Cathy Whatley, “Testimony Before the United States Senate Committee on Banking, Housing, and Urban Affairs, Subcommittee on Housing and Transportation,” (June 20, 2000), available at http://banking.senate.gov/00_06hr062000/whatley.htm.
\textsuperscript{856} Ibid.
upper rungs symbolic of repeat homebuyers.”\textsuperscript{857} What should be ensured is that “every citizen has the opportunity to enter the housing arena.”\textsuperscript{858} The overall message of the hearing in June of 2000 was clear: even with an all-time high percentage of homeownership in America, more resources and ingenuity should be devoted to enabling more Americans to become homeowners. Retrospectively, one can view this hearing as a harbinger of the impending housing bubble.

Another counterposition that was initially comfortable with the one that clung to endlessly rising house prices was that the subprime mortgage crisis, once it began to unfold, would not be severe. A few months after house prices dropped in July of 2006, the United States Senate Committee on Banking, Housing, and Urban Affairs held a hearing on “The Housing Bubble and Its Implications for the Economy.” David Seiders, Chief Economist for the National Association of Home Builders, testified that the “downswing in home sales and housing production should bottom out around the middle of next year [2007] before transitioning to a gradual recovery that will raise housing market activity back up toward sustainable trend by the latter part of 2008.”\textsuperscript{859}

One week later, in front of the same Senate committee, the Chairman of the Mortgage Bankers Association, Robert Broeksmit, claimed that the mortgage market’s success at making subprime mortgages widely available to borrowers was a “positive development, [and] not a cause for alarm.”\textsuperscript{860} He assured the committee that these

\textsuperscript{857} Ibid.
\textsuperscript{858} Ibid.
\textsuperscript{860} Robert D. Broeksmit, “Testimony Before the United States Senate Committee on Banking, Housing, and Urban Affairs, Subcommittee on Housing and Transportation and Subcommittee on Economic Policy,”
mortgages were “being effectively underwritten and managed” by subprime lenders. In the face of rising subprime defaults and delinquencies, he emphasized that “the private market can and does correct for excess risk more quickly than… a regulator who necessarily must move at a more deliberate pace.” Incredibly, Broeksmit stated that “market signals have already addressed many of the concerns” that the Federal Reserve and other federal financial regulators raised in their “Proposed Guidance on Nontraditional Mortgage Products,” unveiled in December of 2005.

As subprime borrower defaults and delinquencies surged and subprime lenders began to fail in early 2007, most notably New Century in March of that year, the Chairman of the Mortgage Bankers Association, John M. Robbins, publicly stated, “For years, we have been calling for legislation to create a tough national standard to protect consumers against predatory lending.” With an influx of “heartbreaking stories of people losing their homes,” Robbins noted that the temptation might be to “have more regulations” and to “have more laws.” The difficulty, from his perspective, was that “regulatory or legislative over-reaction” could make mortgage lenders too conservative and force “first time low to moderate income borrowers” out of the market. The simple fact, Robbins stated, was that there remained “a real need for subprime loans.”

861 Ibid.
862 Ibid., 7.
863 Ibid.
865 Ibid.
866 Ibid.
867 Ibid.
homeownership rate,” which could only be achieved “when every borrower who is creditworthy throughout the entire risk spectrum has access to credit to buy a house.”

Besides, Robbins argued, only “one quarter of one percent [of subprime borrowers] will ultimately face foreclosure.” The disturbances in the subprime mortgage market were not, according to Robbins, macro-economic events. As such, Robbins categorically denied that any “seismic financial occurrence” would “overwhelm the U.S. economy.”

Five days before this speech, on May 17, 2007, Federal Reserve Chairman Ben Bernanke spoke at The Federal Reserve Bank of Chicago’s 43rd Annual Conference on Bank Structure and Competition. After acknowledging the likelihood of more subprime delinquencies and defaults due to impending interest rate resets, Bernanke affirmed that “fundamental factors” were still in place that should continue to support the demand for housing. One of these factors was that the “vast majority of mortgages, including subprime mortgages, continue to perform well.” Speaking on behalf of the Fed, Bernanke concluded, “[W]e believe the effect of the troubles in the subprime sector on the broader housing market will likely be limited, and we do not expect significant spillovers from the subprime market to the rest of the economy or to the financial system.”

In sum, general bias afflicted many of the major players in the subprime mortgage market leading up to the crisis. Adhering to the counterposition of endlessly rising housing prices likely distorted these players’ deliberation efforts, ranging from whether...
one should make a 20% home down payment to whether one should invest in subprime-related instruments. Clinging to that counterposition also probably undermined different individuals’ judgments of fact, most notably judgments centering on the probability and severity of an impending crisis.

2.3. An Introduction to How Group Bias Was Operative Before and During the Subprime Mortgage Crisis

In addition to chronicling how general bias dominated the orientation of central players in the subprime mortgage crisis, one should also note that group bias was prevalent as well. In the chapters that follow, I will explore five broad relationships between parties that were characterized by group bias. These relationships are illustrated in Figure 2.
With respect to group bias, I will discuss in chapter three how the majority of large subprime mortgage lenders “captured” their federal regulators, which resulted in lax or negligent lending regulations. I will show that these regulations, most notably the federal preemption of individual state consumer protection laws, were desirable to the lenders, but inimical to the good of order. These federal deregulation efforts enabled

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874 These regulators are The Office of the Comptroller of the Currency, The Office of Thrift Supervision, and the Federal Reserve.
lenders to pump hundreds of billions of dollars of toxic mortgages into the financial system. A regulatory race to the bottom took place among regulators of subprime lenders, one that had its basis in the fact that lenders paid the regulators to be chartered by them. Those regulators whose oversight was the lightest were the ones who stood to gain the most in lender-paid fees.

In chapter four, I will explore how the five largest arrangers were part of three different relationships that were stamped with group bias: one with the lenders, a second with the Securities and Exchange Commission, and a third with the credit rating agencies. In the first relationship, arrangers either purchased subprime lenders of their own to acquire subprime mortgages or otherwise financed and purchased subprime mortgages from lenders. Incentives were in place for subprime lenders to adopt irresponsible lending practices since arrangers placed emphasis on volume and not quality. In the section on Morgan Stanley, I will probe this arranger’s relationship with New Century Financial, a subprime lender. The second instance of group bias that will be discussed in this chapter is the arrangers’ relationship with the Securities and Exchange Commission (SEC). After heavy lobbying from those five arrangers, the SEC adopted the Alternative New Capital Rule in 2004, which enabled the arrangers to go on a leverage binge, borrowing anywhere from $28 to $35 for every $1 in capital that they held. With this borrowed money, the arrangers were in a better position to purchase incredible amounts of subprime mortgages to securitize and sell to investors.

In chapter five, I will look at how the arrangers were part of a third relationship that was marked by group bias: their relationship with the credit rating agencies. In this

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875 Goldman Sachs, Morgan Stanley, Merrill Lynch, Bear Stearns, and Lehman Brothers.
section, I will argue that the three largest credit rating agencies\textsuperscript{876} were confronted by an arranger demand for triple-A-ratings. In an interesting, though problematic twist, the primary users of credit ratings, the investors, do not compensate the credit rating agencies for their service. Instead, it is the arrangers who pay the credit rating agencies to produce their ratings. The credit rating agencies, therefore, were confronted by a dilemma in the early 2000’s. Since the arrangers wanted their products to be triple-A-rated, and the credit rating agencies were compensated by the arrangers, rating subprime-related products lower than triple-A would be tantamount to biting the hands that fed them. Arrangers were also able to “shop” for ratings, browsing to see which of the credit rating agencies would give the highest rating to their products. Similar to the regulatory race to the bottom that characterized the relationship between federal regulators and subprime lenders, I will argue that the three largest credit rating agencies competed in a ratings race to the bottom: those credit rating agencies that produced the highest, though unjustified, ratings stood to make the most money.

In chapter six, I will argue that the two housing Government-Sponsored Enterprises (GSEs), Fannie Mae and Freddie Mac also had a relationship with Congress that was stained with group bias. Once extraordinarily profitable institutions, in the early 2000’s Fannie Mae and Freddie Mac progressively ventured into purchasing subprime mortgages, as opposed to those of the conforming variety. Congress, which had the authority to specify what Fannie Mae and Freddie Mac could and could not do, was hampered in its oversight by a sizable portion of elected members who opposed GSE regulation in any form. In addition, Fannie Mae and Freddie Mac launched offensive and defensive mechanisms to ensure that their risky operations could proceed unfettered.

\textsuperscript{876} Moody’s, Standard and Poor’s, and Fitch.
Examples of these activities include advertising campaigns, campaign contributions, and lobbying expenditures. One of the most graphic demonstrations of a breakdown in the good order in this study is the spectacular collapse of Fannie Mae and Freddie Mac, which culminated in their being placed into conservatorship in September of 2008.

2.4. How the Invariant Structure of the Human Good Factors into This Study

Each party of the financial crisis that will be examined in the following chapters is responsible for providing at least two simultaneous particular goods. One of these particular goods was profits,\textsuperscript{877} which, if the institution was a publicly traded company, benefited that institution’s shareholders as well as the institution itself. Most of the institutions examined in this study were or still are publicly traded companies. In chapter three, the majority of the lenders that will be examined in detail, such as Washington Mutual, Countrywide, and New Century Financial, were publicly traded companies. Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers, and Bear Stearns, the arrangers discussed in chapter four, were all publicly traded companies – with Goldman Sachs and Morgan Stanley still retaining that status. Of the three largest credit rating agencies examined in chapter five, Moody’s and Standard and Poor’s (whose parent company is The McGraw Hill Companies, Inc.) are publicly traded companies. Finally, Fannie Mae and Freddie Mac, the focus of chapter six, were also publicly traded companies.

In the chapters that follow, I will show how these parties were also responsible for providing at least one other sort of institutional good, in addition to profits. Lenders

\textsuperscript{877} Paul Hoyt-O’Connor, “Bernard Lonergan’s Macroeconomic Dynamics,” 314. Hoyt-O’Connor writes, “Constant normal profit, rather, is a particular good, conditioned by the proper functioning of exchange economies.”
originated and frequently financed mortgage loans for qualified borrowers. The arrangers purchased mortgage loans from lenders, which helped refresh the lenders’ available pool of funds to lend to borrowers. Another institutional good that arrangers provided was the creation of investment vehicles for investors. The credit rating agencies were responsible for providing the investment community with accurate, reliable credit risk assessments. Fannie Mae and Freddie Mac, meanwhile, were entrusted by Congress to create a stable and liquid secondary mortgage market, as well as to make homeownership more affordable.878

The good of order involves providing these particular goods, not once or twice, but in a *recurrent* fashion. Institutional roles are assumed, tasks are carried out, technology is utilized, and an incredible amount of intelligence and energy is exerted to meet this end. What happens, though, if certain conditions pit an institution’s own particular goods against one another? For example, what if the eligible pool of qualified borrowers – or even marginally risky borrowers – begins to shrink? Should employees working within lending institutions haphazardly qualify more undeserved borrowers for mortgages in the interest of bonuses, job security, or company profitability? If arrangers recognize that part of the responsibility of providing investment instruments to investors requires that they hire due diligence firms to scrutinize the quality of the collateral backing those instruments (the mortgage loans purchased from lenders), should they pay those firms to perform appropriate reviews, even though that course of action will reduce their profits? Faced with a potential drop in profitability, should the credit rating agencies refuse to rate certain securities, such as subprime collateralized debt obligations, because they do not have enough experience and historical data to accurately assess the credit risk

878 One should note that a functioning good of order made possible these complex goods.
of those products? As for Fannie Mae and Freddie Mac, should they sacrifice the institutional good of providing a stable secondary mortgage market in order to generate the suddenly opposing institutional good of maximizing returns to shareholders?

These are examples of questions of value that individuals working within institutions may or may not have faced. Whatever questions of value those individuals encountered leading up to and during the subprime mortgage crisis, the quality of their eventual answers – their judgments and decisions – depended upon the possession of a storehouse of accurate concrete judgments of fact (reflective insights) and reasonable, possible courses of action (practical insights). The quality of their judgments and decisions was also dependent upon their individual orientations. To what extent were their horizons limited to the subjectively satisfying (the immediately profitable) and dissatisfying (the immediately unprofitable), or open to the full scale of values? Adequate answers to questions of value cannot be satisfactorily answered solely by considering the magnitude of instances of the particular good, for these goods can conflict, their duration can be short-lived, and their very existence can be contrary to the evaluations by morally converted subjects who adhere to the scale of values.

Writ large, this study will demonstrate that the subprime mortgage crisis was really about a partial, albeit serious, breakdown of the good of order. What accounted for this breakdown was the gradual and steady accumulation of biased decisions. Rising house prices successfully masked any tensions between particular and institutional goods that were being produced. With house prices rising indefinitely, the different parties in the crisis that are considered in this study only needed to discern how to provide more of one sort of good in order to realize more of the other: profit. For lenders, the more
subprime loans they originated, the more money they stood to make via the arrangers. The more loans that arrangers purchased from lenders, securitized, and sold to investors, the more impressive the profits they and their shareholders stood to gain. Since the three largest credit rating agencies were monetarily compensated by volume, they stood to make the most money by rating as many subprime securities as they could. By way of wading further and further into the business of purchasing and securitizing subprime mortgages, Fannie Mae and Freddie Mac satisfied both Congress and their shareholders. If providing certain particular or institutional goods happens to be making money for an institution, the general bias of common sense warranted doing so – even though a broader intellectual and value perspective would judge this procedure to be indiscriminate and careless.

Profitability and the fluid flow of other particular goods during this period of rising house prices also concealed the deteriorating good of order. The particular goods that were not for profit became progressively misleading and destructive. Borrowers were steered into inappropriate and unaffordable mortgages. Lenders misrepresented borrower loan applications and steered borrowers towards pernicious mortgage loans. Arrangers created investment instruments of dubious quality. The three largest credit rating agencies grossly over-inflated their ratings of subprime-related securities. Fannie Mae and Freddie Mac sabotaged much of the secondary mortgage market. In a word, once house prices dropped and the subprime mortgage crisis reached its crescendo, the operations of these institutions seldom functioned as valid forms of cooperation.
2.5. A Preliminary Concern: What is the Definition of “Subprime”? 

By now the reader may have wondered what the term “subprime” or “subprime mortgage” means. A mortgage is “a loan secured by the collateral of some specified real estate property, which obliges the borrower to make a predetermined series of payments.” Subprime mortgages, as defined by Federal Reserve Chairman Ben Bernanke in a presentation that he made at the Federal Reserve Bank of Chicago’s 43rd Annual Conference on Bank Structure and Competition, are “loans made to borrowers who are perceived to have high credit risk, either because they lack a strong credit history or have other characteristics that are associated with high probabilities of default.” Here, Bernanke defines subprime loans in terms of borrower characteristics. Another way of defining subprime loans would be to examine the features of the loans themselves, such as the amount of the loans or the modes of their repayment.

One of the more disconcerting aspects of the subprime mortgage crisis is that there was never an adequate, federally accepted definition of the term “subprime.” To enter an investigation of the importance of this difficulty, consider a March 30, 2004 hearing held by two subcommittees in the United States House of Representatives. The hearing was titled “Subprime Lending: Defining the Market and its Customers.” At the beginning of the hearing, Congressman Robert Ney explained that the purpose of the hearing was to “look at the subprime lending market in the United States,” because

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881 The House Subcommittee on Financial Institutions and Consumer Credit, and the House Subcommittee on Housing and Community Opportunity.
882 United States House of Representatives’ Subcommittees on Financial Institutions and Consumer Credit, and Housing and Community Opportunity, “Subprime Lending: Defining the Market and its Customers,”
during the previous decade “the number of people receiving subprime loans increase[d] dramatically.”\textsuperscript{883} Congressman Ney admitted that the subcommittees did not know whether it was primarily a matter of consumers “who had previously not been eligible for credit… now getting access to the mortgage market,” or if consumers were now simply “paying more for credit.”\textsuperscript{884} In other words, what was unclear was the extent to which the prodigious growth of the subprime mortgage market in the 1990’s was either positive or deleterious.

Congressman Spencer Bachus echoed this concern, noting further that there was a confusion between the terms “predatory lending and subprime lending.”\textsuperscript{885} Subprime lending, according to Congressman Bachus, “is a very legitimate form of financing for housing, home improvements, [and] things of that nature” that has enabled many Americans to own their own home.\textsuperscript{886} He argued that subprime lending “is a good thing if it is not accompanied by abusive lending practices,”\textsuperscript{887} but that “Congress first has to understand the subprime marketplace” in order to enact effective legislation.\textsuperscript{888}

Comments made by two other members of the subcommittees are worth mentioning. Congressman Rubén Hinojosa, after revealing that subprime lending legislation was an issue of “particular concern” to him, stated that “subprime lending has yet to be defined and some claim that it is impossible to define.”\textsuperscript{889} Congressman Hinojosa went on to affirm, “If that is the case, then I wonder if we are chasing our tails

\textsuperscript{883} Ibid.
\textsuperscript{884} Ibid.
\textsuperscript{885} Ibid., 4.
\textsuperscript{886} Ibid.
\textsuperscript{887} Ibid.
\textsuperscript{888} Ibid.
\textsuperscript{889} Ibid., 16.
here today. Perhaps we should wait until it is defined.”

Similarly, Congressman Jeb Hensarling expressed dismay over the fact that, in attempting to forge legislation pertaining to “the issue of subprime lending and [its] evil cousin predatory lending,” there was not “an acceptable definition of what constitutes predatory lending.”

Congressman Hensarling reasonably suggested that “it is going to be very difficult to legislate against something that we are having a little trouble defining in the first place.”

What these comments suggest is that as early as 2004, prior to the eruption of the subprime mortgage crisis, at least some members of Congress recognized that an established, federally-approved definition of the term “subprime” was needed in order to understand the nature and risks posed by the subprime mortgage market.

Over four years before that joint hearing, The Department of Housing and Urban Development (HUD) published a report in September of 1999 that called attention to this problem:

There is no general agreement on the definition of the subprime market. A narrow definition of subprime lending would include only loans originated for borrowers with blemished credit histories. Even this narrow definition, however, has operational problems because lenders often disagree [over] what constitutes a blemished credit history.

In other words, if one’s definition of the term “subprime” only includes borrower characteristics, then each mortgage lender would have at least a certain amount of freedom to determine what qualifies a given borrower as one with a blemished credit history and what does not. For instance, one lender could label a mortgage loan subprime

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890 Ibid.
891 Ibid., 60.
892 Ibid.
when a borrower has a FICO score of, say, 660 or less and the borrower is unable to completely document his or her past income over a given period of time. Another lender may find it advantageous to label a mortgage loan subprime if the borrower is unable to provide a 20% down-payment on the house, does not have private mortgage insurance, and has a FICO score of 650 or less. The important point is that a definition of subprime that only incorporates the characteristics of the borrower is one that is bound to lead to operational problems because the multitude of mortgage lenders will determine, at least to some extent, the sort of borrowers who are fit for a subprime mortgage.

One researcher estimated that there were over 20,000 lenders in the United States that were originating subprime loans in 1997, which, in theory, could have given rise to an incredible variety of interpretations of what constitutes a subprime mortgage, borrower, or lender.894 The aforementioned 1999 HUD report identified approximately 200 lenders that were specializing in subprime and niche lending that year.895 As a March 9, 2004 report published by Harvard University’s Joint Center for Housing Studies makes clear, the considerable variation in “the definition of what constitutes ‘a subprime mortgage’ hinders precise measurement.”896 Not only does a lack of an authoritative definition of the term “subprime” preclude one from knowing exactly how many subprime mortgages have been originated, one will also not have a firm grasp of what a subprime mortgage, borrower, or lender is.

Particularly revealing is an interagency statement issued by the five most important regulators of the United States mortgage market in March of 2007.\textsuperscript{897} As the grave risks posed to the economy by subprime mortgages became more and more evident in early 2007, the five regulators released a publication titled, “Proposed Statement on Subprime Mortgage Lending.” In this statement, the regulators assert, in a footnote, that they defined the term “subprime” in 2001 in a previous publication called “Expanded Guidance for Subprime Lending Programs.”\textsuperscript{898} The regulators expressed concern in the 2007 statement about a number of issues surrounding subprime mortgages, including (1) the lack of understanding on the part of subprime borrowers concerning the risks and consequences embedded in the terms of their mortgages, (2) predatory lending issues, (3) subprime mortgage underwriting standards, and (4) principles designed to protect potential subprime borrowers.\textsuperscript{899} As regards the crucial character of the subprime mortgage market, precisely how the regulators defined “subprime” in their 2001 publication is critically important.

Turning to the regulators’ 2001 report, “Expanded Guidance for Subprime Lending,”\textsuperscript{900} the definition of the term “subprime” occurs on the first page: “The term ‘subprime’ refers to the credit characteristics of individual borrowers.”\textsuperscript{901} The regulators

\textsuperscript{897} These regulators are the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision (OTS), and the National Credit Union Administration (NCUA).


\textsuperscript{899} Ibid., 6-8.

\textsuperscript{900} Only four of the five regulators published this report. The National Credit Union Administration is not listed as a contributor.

It is astounding that the regulators’ definition of the term “subprime” in their 2001 statement, which was intended to serve as a mere “starting point” for their examination of the subprime market, did not evolve over the course of six years, as the subprime market itself dramatically grew in size and complexity. Although the regulators acknowledged the limitations of their definition in 2001, underscoring how it is confined to borrower characteristics, such limitations could lead to discrepancies between their conception of a subprime mortgage, lender, or borrower, and that of subprime lending institutions. In other words, the regulators were aware of the same deficiencies in their 2001 definition of subprime that the HUD identified in 1999: the definition is too narrow and invites uncontrolled variations in what constitutes a subprime mortgage, borrower, or lender and what does not. Unsurprisingly, when the regulators requested comments on all aspects of the 2007 proposed statement from the general public, one of the key criticisms of the statement was that there was needed a clarification of “the scope of the proposed statement and the definition of ‘subprime.’”904 Indeed, how can one understand the scope

902 Ibid., 3.
903 Ibid.
of subprime lending (or borrowing, for that matter) if one does not have a firm grasp of
what is meant by “subprime”?

In perhaps recognizing that the term “subprime” persisted in having amorphous
boundaries all the way up through 2009, the Government Accountability Office (GAO)
opted to use the term “nonprime” in their report titled “Characteristics and Performance
of Nonprime Mortgages” released that year. In an effort to make a distinction between
two sorts of nonprime mortgages - subprime and Alt-A - the GAO resorted to speaking in
general terms about both kinds of mortgages, conceding that the categories are “not
rigidly defined.”

The ambiguity of the term “subprime” and the difficulties that accompany it were
conspicuously evident in an April 2010 report published by one of the most important
regulators of mortgage lenders in the United States, The Office of the Comptroller of the
Currency (OCC). In this report, the OCC attempts to identify the extent to which different
types of lending institutions were involved in subprime lending “during the period
preceding the financial crisis.” In respect of the seriousness of the financial crisis, this
was an investigation of paramount importance. Yet one should note the OCC’s caveat on
the very first page of the report. After affirming that the number of subprime loans
originated by national banks “was small relative to the total subprime market,” the OCC
admits that “analyses by others have reached conflicting conclusions, finding

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905 Government Accountability Office, “Characteristics and Performance of Nonprime Mortgages,” (July
906 The Office of the Comptroller of the Currency, “Appendix B: Activities of National Banks Related to
significantly higher percentages of overall subprime mortgage lending [by national banks].”\textsuperscript{907} Moreover, the OCC alarmingly declares:

To some extent the existence of conflicting [subprime lending] estimates is not surprising. Developing precise estimates of subprime lending activity is difficult because comprehensive data for the market simply do not exist, from either private or public sources. Statements about subprime activity also suffer from lack of agreement at a more basic level regarding how to define “subprime” or other variants of nonprime mortgage loans.\textsuperscript{908}

The fact that there was not an official federally recognized definition of the term “subprime” more than a year after the subprime crisis began to unfold is distressing. To my knowledge, such a definition still does not exist. How can the OCC ensure “a safe and sound national banking system for all Americans,”\textsuperscript{909} when one of the most serious threats to that system’s safety and soundness was not – and is still yet to be – defined in a meaningful way? The same concern applies to the other regulators of our financial system and it should serve as a backdrop for any discussion that includes subprime lenders, brokers, borrowers, or investors.

Over the course of my research on the subprime mortgage crisis, I have encountered significant variations in the usage of the term “subprime.” In some instances, the author or authors using the term offered definitions of it, while in other cases they did not. In this study, I will present, or at least cite where one can find, a given source’s definition of subprime on those occasions when a definition was offered. Regrettably, though unavoidably, my usage of the term subprime will, over the course of this dissertation, vary according to how the term is used by the sources to which I refer.

\textsuperscript{907} Ibid.
\textsuperscript{908} Ibid., italics mine.
\textsuperscript{909} This slogan is taken from the OCC’s official website, available at http://www.occ.treas.gov.
2.6. Historical and General Background Information on the Mortgage Industry

We have to make a key distinction between the primary market and the secondary market in order to understand the subprime mortgage crisis. The primary mortgage market is one in which lenders originate loans that are typically financed by depositors and then distribute these loans to borrowers. In this market, the lenders ordinarily hold on to these loans and use the payments made by the borrowers to pay out interest to its depositors as well as enable them to withdraw their money at some predetermined period. Lenders make a profit in the primary mortgage market by charging borrowers a higher interest rate on their home loans than the interest rate that they offer depositors to put their money in savings accounts. Up until the late 1980’s to early 1990’s, the American mortgage market was largely a primary one, dominated by the thrift industry. The major players in this market were thrifts (lenders), borrowers, depositors (who financed the mortgage loans), appraisers (who assessed the value of the real estate desired by the borrower), and the Federal Reserve System (the system which determined the market interest rates).

Recurrent problems in the primary mortgage market, which came to a head in the Savings and Loan Crisis of the mid-to-late 1980’s, created certain conditions for the emergence of a solid secondary mortgage market, in which lenders not only made loans to borrowers, but they also sold them to interested buyers. Strictly speaking, the secondary market had existed for several decades prior to the early-to-mid 1990’s, as thrifts could sell loans to other thrifts as needed, or federally chartered thrifts could sell their loans to the Federal Home Loan Mortgage Corporation (Fannie Mae) as long as the
loans conformed to Fannie Mae’s standards. Nevertheless, the primary mortgage market prevailed throughout the twentieth century up until the early 1990’s.

As complicated as the primary mortgage market both was and still is, the secondary mortgage market adds innumerable further complexities. To be sure, the rise of the secondary mortgage market centered on what was perceived to be a desirable transfer of risk because of increased efficiency and the influx of extra liquidity. Lenders could now sell the loans that they originated to buyers who were looking to invest their money in reliable assets. From 1968 through 2006, the median price of houses never fell on a year over year basis, which made real estate an attractive investment opportunity. As opposed to having depositors place money into interest-bearing savings accounts and using that money to finance mortgage loans, it seemed reasonable to allow interested investors to somehow put their money directly or indirectly into financing those loans. Those who were, in theory, better suited to handle the risks involved in investing in mortgage loans would be the ones who would finance the loans. It would be a mistake, however, to assume that the shift to the secondary mortgage market in the mid-1990’s arose because of the assumption that investors could probably manage risk better than unsuspecting depositors. As I will show in a moment, the main reason that the secondary market exploded after the Savings and Loan Crisis was because of the desperate need for liquidity. It is fascinating that the extra step of buying and selling mortgages on the secondary market has resulted in the creation of an extraordinarily large and elaborate

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910 In 1970, Congress created the Federal National Mortgage Corporation, known as Freddie Mac, whose function was to buy and sell home loans from thrifts. At the same time, Congress enabled Fannie Mae to buy and sell any type of home loan. Two years prior to this legislation, the Government National Mortgage Association, known as Ginnie Mae, was created to buy FHA and VA loans, and to issue securities that could be invested in by interested parties. However, despite the presence of a secondary market prior to the mid-1990’s though, the important point is that the secondary market during this time was relatively dormant. See Ned Eichler, *The Thrift Debacle* (Berkeley: University of California, 1989), 46; Please see also: *S&L Hell*, 57.
industry, one whose success, as in all industries, is contingent upon the proper functioning of its participants.

One final note before I begin to map out some of the historical highpoints of the mortgage industry in twentieth century America. An additional benefit of the secondary market is that it made home mortgages available to more people. Within the primary mortgage market, a risky borrower was, generally speaking, denied access to home financing, since a failure to repay the loan would disrupt a thrift’s ability to pay interest on and return to its customers’ deposits. As mentioned before, the secondary mortgage market gave riskier investors the opportunity to invest in riskier products – and these products happened to be the loans of riskier borrowers. Riskier borrowers were charged a higher interest rate to borrow money, which, from the point of view of investors, opened up the possibility for larger returns on investments, assuming that the borrowers repaid their debt. The benefits of the secondary market were clear enough: two sets of demands would be more adequately met by two sets of supply. Matched with the demand of borrowers to have access to home loans was the supply of money provided by investors. Similarly, the demand of investors for a seemingly reliable and rich source of potential profit was met by a diverse supply of borrowers with varying degrees of risk, who were seeking to take out more expensive loans in order to share in the American Dream of homeownership.
2.7. Historical Preconditions for the Emergence of the Subprime Mortgage Market, and the Crisis That General Bias Forgot: The Savings and Loan Crisis

Up until the late 1980’s, thrifts were the clear leaders in mortgage loan originations. Thrifts earned their name from their traditional emphasis on savings accounts for small depositors. Thrifty customers would make routine savings deposits and receive interest on them in exchange for agreeing to only withdraw the money after certain specified periods. In turn, the thrift would pool the deposits together and distribute home loans to its customers when possible. By lending at a higher interest rate than what was to be paid in interest to their depositors, thrifts were able to make a profit. The primary task of a thrift was to efficiently bring together people who had extra money with those who wanted to borrow.911

The American homeownership rate from 1890 to 1930 ranged from 45.6% to 47.8%, but largely due to the Great Depression, the homeownership rate dropped to 43.6% by 1940.912 During the Great Depression, over 1,700 thrifts failed, while thrift customers lost over $200 million in deposits.913 Aside from causing Americans to lose confidence in the thrift industry, its collapse also radically reduced the amount of money available to finance home loans. In a remarkable series of decisions, Republican President Herbert Hoover and Democratic President Franklin Roosevelt successfully worked with Congress to pass three striking pieces of legislation, all with the aim of aiding the thrifts to promote homeownership.

The Federal Home Loan Bank Act of 1932 created a system of twelve regional Federal Home Loan Banks (FHLB’s) that were permitted to borrow money at low

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913 S&L Hell, 42.
government rates in order to lend it to thrifts at below-market rates. The idea was that since the thrifts could now pay less to borrow money, they could pay higher interest to their depositors. The prospect of higher returns gave depositors an incentive to return to the thrifts, which enabled the thrifts to once again use those deposits to finance home loans. The Federal Home Loan Bank Act also created the Washington-based Federal Home Loan Bank Board for the purposes of overseeing the twelve regional FHLB’s.

The second crucial piece of legislation that aimed to reinvigorate American home ownership during the 1930’s was the National Housing Act of 1934, which created both the Federal Savings and Loan Insurance Corporation (FSLIC) and the Federal Housing Administration (FHA). The FSLIC was designed to “provide a deposit insurance system for thrifts,” insuring a maximum amount of $5,000 per account. By insuring deposits, thrifts were able to win back the confidence of depositors and ultimately raise more money to finance home loans. The FHA, on the other hand, provided mortgage insurance to under-qualified borrowers in an effort to make homeownership more available to a larger proportion of the population. In particular, the FHA targeted borrowers who did not have enough savings to make the typically required 20% down payment on a house. Thrifts were given the incentive to loan to under-qualified borrowers based upon the understanding that if any borrower did not pay back his or her loan, the FHA would pay back the remaining balance. One astute thrift executive at the time discerned the

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914 Ibid.
916 Ibid., 57.
potential for what is now known as moral hazard: when less liabilities are present (in this case due to the insurance), there is greater potential for an increase in risky behaviors.917

Despite the government’s efforts to make homeownership more available to more Americans, the FHA-backed loans in the mid-1930’s were not as popular as they were initially expected to be. As a result, in 1938, Roosevelt and Congress worked together to create a “quasi-government company” called the Federal National Mortgage Corporation, commonly referred to as Fannie Mae. Thrifts or other sorts of lenders that were previously reluctant to originate FHA-backed loans were reassured that Fannie Mae would agree to buy those loans from them, which provided the originating lender with fresh cash to make more FHA-backed loans.918 Thrifts, for the most part, resisted making FHA-backed loans, however, and elected instead to finance loans the traditional way: by attracting depositors to put their money into interest-bearing savings accounts and pooling together those deposits to finance home loans. For present purposes, the important point is that the United States government clearly valued the ideal of widespread homeownership.

By 1945, the number of thrifts fell from a peak of 12,500 to about 6,700.919 Shortly thereafter, however, there was a remarkable veteran-driven housing boom that lasted until about 1965. The thrift industry flourished during this period, with their assets doubling every five years.920 “3-6-3” was how the industry was described, meaning that thrifts “could take in money at 3 percent interest on deposits; they could lend it out at 6 percent interest in mortgage loans; and thrift executives could be on the golf course by

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917 S&L Hell, 43.
918 Ibid., 44.
919 Ibid., 50.
3:00 in the afternoon." 921 One noteworthy development during this period was the creation of the fixed-rated 30 year mortgage. By spacing out predictable and affordable payments, millions of Americans were suddenly able to afford homes. 922 Over 15 million homes were built in the 1950’s, more than twice the amount built in the 1940’s and over five times the amount built in the 1930’s. With the economy expanding and incomes rising, the American homeownership rate leaped to over 60% by 1965. 923

As the United States became involved in the Vietnam War in 1965, however, government spending increased, which led to a subsequent rise in market interest rates. From September of 1964 to September of 1966, the interest rates on three month Treasury Bills jumped from 3.53% to 5.36%. 924 This increase in market interest rates placed many thrifts in a difficult situation. In the previous two decades, low market interest rates enabled thrifts to make a reliable profit by consistently offering home loans at a higher interest rate than the one that they gave their customers on their savings deposits. As the monthly mortgage payments arrived, the interest earned on the principal of those loans would be more than the interest paid out on deposits. Now, however, with market interest rates rising, thrifts were compelled to raise the interest rates that they offered on savings deposits, for if they refused to do so, they would lose customers to competing investments, such as higher-yielding Treasury Bills. If they lost customers to competing investments, their ability to finance new mortgages would be severely crippled. Of course, thrifts could attempt to sell their mortgage loans, which had suddenly

921 Ibid.
922 Subprime Mortgages: America’s Latest Boom and Bust, 13.
923 Ibid.
924 The S&L Debacle: Public Policy Lessons for Bank and Thrift Regulation, 62.
become less profitable, but they would have likely had to sell them at a loss. This turn of events beginning in 1965 exposed a serious flaw in the thrift industry: namely, that thrifts borrow money from depositors for the short-term, but they loan that money to borrowers for long periods of time. Volatile market conditions can make such an approach to borrowing and lending profitable when market interest rates are low, but when market interest rates are high, this approach is unsustainable.

The thrift crisis in 1965-1966 came to be known as the Disintermediation Crisis. Disintermediation is the process by which depositing institutions, like thrifts, lose funds to higher-yielding investments. It was viewed as a crisis because not only did thrifts have money tied up in older, long-term, low-rate mortgages, they also struggled to maintain any incoming cash flow to finance new mortgages. Another issue of concern was that thrifts might recklessly raise the interest rates that they would pay on deposits with the hope of continuing to finance new home loans at even higher interest rates. Should a thrift who adopted such a strategy be unable to overcome the losses of the older mortgages and begin to fail, the American population, it was thought, could potentially lose confidence in the thrift industry once again, resulting in rampant withdraws that the thrifts could not cover.

Anticipating such a danger, Congress passed the Interest Rate Control Act (IRCA) in September of 1966. The IRCA included Regulation Q, which placed ceilings on the interest rates that thrifts could pay on deposits. From September of 1966 to December

925 Ibid.
926 Ibid., 61.
927 Subprime Mortgages: America’s Latest Boom and Bust, 14.
of 1969, the interest rate ceiling that thrifts could pay on deposits was 4.75%; from January of 1970 to June 1973, the ceiling was 5.00%; from July of 1973 to June of 1979, the ceiling was 5.25%. Year over year, the interest rate ceiling on thrift deposits only exceeded that of three month Treasury Bills four times, which did not create a strong incentive for Americans to deposit their money in thrifts. In an effort to dissuade Americans from investing their money in the frequently more profitable Treasury Bills, Congress raised the minimum denomination of Treasury Bills from $1,000 to $10,000 in 1970. Since the average deposit in a thrift at this time was $3,045, many Americans were unable to invest in the higher rate Treasury Bills and had to resort to depositing their money in lower-yielding thrift savings accounts. As Lawrence White notes, Congress’ efforts in the mid-to-late 1960’s and well into the 1970’s only served as a “patch” that “delayed the day of reckoning for the thrift industry.” The tension between borrowing short and lending long was not resolved during this period.

The drastic increase in market interest rates in the late 1970’s coupled with the development of money market mutual funds proved to be devastating changes to the thrift industry. In January of 1978, the market interest rate was 6.49%, with thrifts paying out 5.25% on deposits. By January of 1981, the market interest rate had risen to an astounding 14.72%. These conditions gave Americans the incentive to pull their money out of the thrifts and invest instead in money market mutual funds, which pooled together the moneys of many investors and placed them in, among other things, Treasury

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930 Ibid., 63.
931 Ibid., 64.
932 Ibid., 65.
933 Ibid., 69.
Money market mutual funds effectively gave Americans the opportunity to invest their money in ways that were previously unavailable to them due to high deposit minimums. In 1977, money market mutual funds held only $3 billion, but by 1982 they held $233 billion. The thrift industry lost approximately $6.9 billion in 1981 and $22.2 billion in 1982. It was the beginning of the Savings and Loan Crisis, which lasted well into the middle to the end of the 1980’s.

Congress, along with Presidents Carter and Reagan, attempted to avoid the impending crisis by passing two pieces of legislation: The Depository Institutions Deregulation and Monetary Control Act (DIDMCA) of 1980 (signed by Carter) and The Garn-St. Germain Depository Institutions Act of 1982 (signed by Reagan). Of the many changes that these acts brought about, only four will be considered here. First, thrifts were allowed to offer Adjustable Rate Mortgages (ARMs) to their customers, with no loan-to-value ratio limits on them. It is important to note that the government initially viewed ARMs as being desirable because of their perceived ability to be more lender-friendly, as opposed to borrower-friendly. ARMs shift the risk of market interest rate changes away from the lender and place it on the borrower. From the lender’s perspective, ARMs evade the problem of being locked into low-rate, long-term mortgages when market interest rates rise. Offering these loans at 100% home financing, however, increased the probability of borrowers failing to repay the entire loan plus

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934 Ibid., 68.
935 S&L Hell, 60.
936 The S&L Debacle: Public Policy Lessons for Bank and Thrift Regulation, 71.
937 Ibid., 73.
interest. Surprisingly, heightened regulation such as the need for “better information, higher scrutiny, and higher net worth standards” did not accompany the increased risk.\textsuperscript{938}

The second change that these acts brought about was that they permitted thrifts to offer products that were traditionally reserved for commercial banks, such as credit cards and loans for automobiles.\textsuperscript{939} This change ended up blurring the previously clear-cut distinction between thrifts and commercial banks that had persisted throughout the late 19\textsuperscript{th} century and the majority of the 20\textsuperscript{th} century. Third, an increase in deposit insurance was authorized for a maximum amount of up to $100,000 per savings account. Finally, Regulation Q, which was implemented by the IRCA in 1966, was abolished. Regulation Q placed interest rate ceilings on the amount that thrifts could offer their depositors. Each thrift was now able to adjust its interest rate in response to the market rate, making it more competitive with the money market mutual funds.\textsuperscript{940}

The combination of being permitted to offer higher interest rates on deposits and riskier loans to borrowers, all the while having a $100,000 safety net in the form of FSLIC-sponsored deposit insurance on each savings account, was an optimal combination for moral hazard. The deposits that financed riskier home loans were guaranteed by FSLIC, giving thrifts the incentive to privilege potential gains over potential losses. The tax paying public was on the hook for potential losses, while the thrifts stood to privatize their profits, should those risks pay off. In an important sense, this arrangement resembled the subprime mortgage that erupted roughly twenty years later.

\textsuperscript{938} Ibid., 75.
\textsuperscript{939} Ibid., 73.
\textsuperscript{940} Ibid., 74.
Astonishing decisions were made over the years following the implementation of the DIDMCA and the Garn-St. Germain Depository Institutions Act. For example, Stanley Adams, manager of Lamar Savings and Loan in Austin, Texas, attempted to use deposits to invest in opening a branch on the moon. Unreasonable spending on “new corporate headquarters, executive salaries, client entertaining, [and] company parties” took place at many thrifts. Don Dixon, a manager of Vernon Savings and Loan in Dallas, Texas, used deposits to buy luxury cars costing $1.8 million, a beach house costing $2 million, and flowers for his wife costing $36,760. Still, Lawrence White argues that the majority of the thrifts’ problems during the Savings and Loan Crisis were not the product of such criminal and irresponsible activities. Rather, White claims, the thrifts “largely failed because of an amalgam of deliberately high-risk strategies, poor business judgments, foolish strategies, excessive optimism, and sloppy and careless underwriting, compounded by deteriorating real estate markets.” White made this claim in the early 1990’s, and it is striking how much of this diagnosis can be said to apply to the current subprime mortgage crisis.

In a ten year span, between 1980 and 1989, approximately 890 thrifts with $347.8 billion in assets failed, with the smaller thrifts going out of business first, and the larger ones failing last. Almost 35% of all thrifts were wiped out by the end of the decade. The total cost to taxpayers to bail out the failed, insolvent thrifts ended up being over

$100 billion. In 1980, roughly 49.7% of home loan originations were made by thrifts, but by 1997, this figure fell to 18.3%, due in part to the severe sanctions imposed on thrifts by the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989. It was under these turbulent conditions that the secondary mortgage market truly began to emerge as the main arena for financing mortgages. Any study of the secondary market as it developed and functioned in the 1990’s up until the present time, must account for conditions that it responded to as well as the degree to which it successfully overcame the limitations that the primary market faced.

2.8. The Original Subprime Mortgage Crisis: Also Consigned to Oblivion by General Bias

One of the more disheartening characteristics of the subprime mortgage crisis is that it was preceded by a lesser-known, less severe subprime crisis that took place in the late 1990’s. This original subprime boom and bust serves as an exemplary instance of general bias because it should have served as a clarion call to regulators of and participants in the subprime mortgage market in the early 2000’s. Yet, for reasons that will be explored in later sections of this study, the original subprime crisis made no such impact. It will be helpful to explore this original subprime crisis in some detail.

The Savings and Loan Crisis of the 1980’s and early 1990’s was undoubtedly one of the most serious financial catastrophes in American history. A former Federal Deposit Insurance Corporation chairman admitted that the S&L crisis was instigated “almost

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946 Subprime Mortgages: America’s Latest Boom and Bust, 15.
947 Financing Residential Real Estate, 56.
uniformly [by]… real estate loans,” ultimately resulting in the failure of nearly 3,000 deposit-taking institutions and costing an estimated $160 billion to offset all of the losses. Approximately 1,600 deposit-taking institutions that were insured by the FDIC either closed down or received its financial assistance. More than 1,000 executives at those institutions were convicted of felonies. Quietly, as the S&L clean-up efforts began to wind down in the early 1990’s, the seeds of the next American mortgage crisis, one that would begin to unfold in 1998, were already being sown.

Beginning in 1994, the number of applications for both conventional mortgages and conventional mortgage refineses dropped precipitously. Market interest rates increased by more than 2% during the first six months of 1994 alone. Someone who had recently obtained a mortgage prior to this sudden increase in market interest rates would likely now be discouraged from refinancing at a higher rate, while someone who was in the market for a mortgage might find the new mortgage rates to be unattractive enough to delay purchasing a home. This is borne out by the fact that from 1993 to 1995 total mortgage originations dropped by a glaring 36%. Many mortgage lenders during this period were scrambling to find ways to broaden their market base as the conventional

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954 Ibid.
955 Ibid.
mortgage market dried up. This was a significant moment for the initial growth of the subprime mortgage market in the United States.

Four different articles, all of them written between late-1995 and early-1996, serve as an informative window into the mortgage lending industry’s sentiment towards subprime mortgages at this time. The first article, written in early 1996, bears the headline: “Lenders Told to Get Ready for a Growing Market in Lower-Quality Loans.” The author, Juliana Ratner, reports on what transpired at an early 1996 conference on subprime lending, sponsored by the National Real Estate Development Center. The major theme of the conference, according to Ratner, was: “Nonconforming loans are losing their stigma as the ugly stepchildren of the mortgage family.”

This assessment of subprime mortgages was mirrored in another article that was written in September of 1995. Then-President of Quality Mortgage USA, Neil Kornsweit, is quoted as declaring, “For a long time, most lenders treated borrowers with marred credit records as pariahs, but that mindset is changing.” Another article, written in February of 1996, contains the quote: “Some bankers… are discovering what finance companies have known all along: not all customers with bad credit are bad customers. They can be the source of far greater yields than the typical borrower in a bank’s

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956 Ibid.
959 Ibid.
960 Amresco Inc. purchased Quality Mortgage USA in October of 1996.
customer loan portfolio.”

A fourth and final article, this one written in December of 1995, covered the National Home Equity Mortgage Association’s southeastern conference. Of particular interest is the discussion of one of the sessions at the conference titled: “Untapped Potential in the Home Equity Market.”

Glen Stein, Vice President of asset-backed securities at Prudential Securities Incorporated, argues in the article that subprime loans “have several advantages over traditional high-credit-quality loans” including the fact that subprime borrowers “are more concerned with making payments than on getting the best interest rates.”

The lure of subprime mortgage lending was so powerful that there were about 200 lenders who were strongly in the subprime business by 1995. GE Capital, Chase Manhattan and Chemical Bank (which merged in 1995), Norwest Mortgage Corporation (which merged with Wells Fargo in 1998), and General Motors Acceptance Corporation (which changed its name to Ally Financial in 2010) were among the largest subprime lenders in 1995. In 1996, the five largest subprime mortgage lenders were, in order, Associates First Capital Corporation (which was

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964 Ibid.
965 Karen Talley, “Keep Your Guard Up in Subprime Game, Lenders are Warned.”
purchased by Citigroup in September of 2000),\textsuperscript{971} The Money Store (which was purchased by First Union Corporation\textsuperscript{972} in June of 1998), ContiMortgage Corporation (which was a unit of ContiFinancial, a company that filed for bankruptcy protection in May of 2000),\textsuperscript{973} Beneficial Mortgage Corporation (which was purchased by Household International in 1998),\textsuperscript{974} and Household Financial Services.\textsuperscript{975}

The United States Department of Housing and Urban Development (HUD) noted in an April 2000 report that there was “a monumental growth in subprime lending” from 1993-1998.\textsuperscript{976} Subprime refinance loans alone increased nearly 900% over this five year span from 80,000 in 1993 to 790,000 in 1998.\textsuperscript{977} Two months later, HUD issued a joint report with the United States Treasury Department titled, “Curbing Predatory Home Mortgage Lending.”\textsuperscript{978} In this report, the two government agencies document that subprime mortgage originations totaled around $35 billion in 1994 and rose to $150 billion by 1998, an increase of 328%.\textsuperscript{979} The agencies also note that the “securitization of subprime mortgages [that] has developed in the past few years… has contributed

\textsuperscript{975}Household International, after a $484 million predatory lending settlement, was purchased by HSBC in November of 2002. Andrew Ross Sorkin, “HSBC to Buy a U.S. Lender for $14.2 Billion,” The New York Times (November 15, 2002). Household Financial Services was a unit of Household International.
\textsuperscript{977}Ibid., 2.
\textsuperscript{979}Ibid., 29.
significantly to the rapid growth of the market.”980 Whereas $11 billion worth of subprime mortgage-backed securities were issued in 1994, $83 billion were issued in 1998, an increase of over 654%.981

Unquestionably, one of the major factors that accounted for subprime lending’s towering growth in the 1990’s was the veritable explosion of outstanding consumer debt during this period. According to data provided by the Federal Reserve, at the end of January of 1990, outstanding consumer debt in America totaled $797.7 billion.982 Jumping halfway through the decade, to the end of December of 1994, outstanding consumer debt rose to $997.3 billion, an increase of over 25%. By the end of December of 1999, the amount of outstanding consumer debt ballooned to $1.53 trillion. Looking at the 1990’s as a whole, outstanding consumer debt in America increased nearly 92%.983

Credit card debt played a significant part in this trend of increasing consumer debt in the 1990’s. From the 1994 to 1995, the amount of credit card debt that was 90 days past due grew 35%, from $2 billion to $2.7 billion.984 A 1996 article in The Economist reported that over that same period, “Americans received a total of five billion direct mail credit card solicitations – equivalent to 32 invitations for each citizen between the ages of 18 and 64.”985 Over the course of just the first eight months of 1995, credit card debt in

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980 Ibid., 2.
981 Ibid.
982 Federal Reserve System, Statistical Release: Consumer Credit (February 7, 2011), available at http://federalreserve.gov/releases/g19/hist/cc_hist_sa.txt. To put this number in perspective, outstanding consumer debt in America, at the end of January of 1960, 1970, and 1980 was, respectively, $56.01 billion, $127.8 billion, and $350.4 billion. Outstanding consumer debt in America, over a 30 year period from the end of January of 1960 to the end of January of 1990, increased an astonishing 1,324%.
983 Ibid.
984 Christine Dugas, “Rising Tide of Debt: Many Families are Living on the Edge,” USA Today (October 30, 1995).
America increased 13%, while incomes only grew at a rate of 3%. In 1996, American consumers charged over $1 trillion to their credit cards owing approximately $360 billion by the end of the year. Overall credit card delinquencies, a key contributor to a borrower being considered “subprime,” were at 3.8% at the end of 1996, an increase of over 72% compared to credit delinquencies in 1988.

Another troubling trend throughout the 1990’s was the surge in personal bankruptcy filings. In 1990, there were 718,107 consumer bankruptcy filings. By the end of 1999, this figure reached 1,281,581, an increase of over 78%.

These figures are important because the increase in subprime lending that took place in the 1990’s was not caused by a mere unilateral phenomenon, i.e. by mortgage lenders, discouraged by the profit potential in the conventional mortgage market, aggressively entering into the subprime market. Instead, these opportunistic lenders were “greeted” in their search for profits by a newly minted influx of borrowers with impaired credit. In other words, although there was an increase in supply of subprime mortgage credit in the 1990’s, this supply “encountered” an ever-growing customer base that could not qualify for prime mortgages. As one journalist, writing for The New York Times, observed in 1997, “the relentless growth in the number of Americans with blemishes on their credit records, ranging from repeated late payments to outright bankruptcy,” made this immense pool of subprime borrowers “too large to ignore.”

986 Christine Dugas, “Rising Tide of Debt: Many Families are Living on the Edge.”
988 “American Consumer Debt: The Cutting Edge.”
989 Ibid.
991 Ibid.
A 1997 article in *The American Banker* provides an interesting glimpse into the budding subprime mortgage market at this time. Author Heather Timmons states, “Current economic factors promise to funnel more consumers into the [subprime] market. Credit-card delinquencies rates are rising, bankruptcies are at record levels, and consumer spending has not slowed.”

Timmons asked an unnamed CEO of a subprime lending institution whether he was worried about “those signs of excess,” to which the anonymous CEO replied, “Really, rising credit card delinquencies just mean more customers for us.”

Despite the fact that “Wall Street had been mesmerized by the rapid growth of the subprime sector” throughout 1995 and 1996, with subprime mortgage lenders experiencing “two phenomenal years,” critics of this expansion became progressively concerned over the stability of the subprime mortgage market by 1997 and early 1998. With an annual average unemployment rate under 5% in 1997 and 1998, the median average household income increasing for the third and fourth consecutive year, and home prices rising, some economists were alarmed by the growth of consumer debt, personal bankruptcy filings, and, in 1998, subprime delinquencies. One economist

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994 Ibid.
995 Barnaby J. Feder, “A Risky Business Gets Even Riskier; Big Losses and Bad Accounting Leave ‘Subprime’ Lenders Reeling.”
declared, “We’ve got an extraordinary debt problem, especially in what should be glowing expansion.”\textsuperscript{1001} Another warned that “an inevitable recession, with a drop in real estate prices, would be fatal for the subprime sector.”\textsuperscript{1002} A consulting firm, in 1996, analyzed the subprime mortgage market and produced a study that predicted that “by lowering their credit standards and saturating the market with loans,” many subprime lenders “will be unable to avoid potentially enormous delinquencies and write-offs.”\textsuperscript{1003}

As these portents anticipated, and similar to what occurred in the more recent and serious subprime mortgage crisis, the tremendous growth of the subprime mortgage market in the mid-1990’s could not be sustained for an extended period of time. Two events that culminated and converged in August of 1998, according to The Financial Crisis Inquiry Commission, an independent, ten-member panel created to “examine the causes of the current financial and economic crisis in the United States,”\textsuperscript{1004} contributed to a market disruption that came to be known as “The Panic of 1998.” The two events were The Russian Default Crisis and the near-collapse of the hedge fund firm, Long-Term Capital Management. The market turmoil that ensued once those events unfolded led to a “shakeout” of subprime lenders in late 1998.\textsuperscript{1005} A brief explanation of these events is warranted.

On August 17, 1998, Russia was “forced to default on its sovereign debt, devalue the ruble, and declare a suspension of payments by [its] commercial banks to foreign

\textsuperscript{1001} Heather Timmons, “Balloonin Subprime Market Runs Risk of Bursting in 1997.”
\textsuperscript{1002} Ibid.
\textsuperscript{1005} Mary McGarity, “Considering Subprime?,” \textit{Mortgage Banking}, Vol. 61, No. 1, (October 2000), 67.
Three days before those developments, the exchange rate for the Russian ruble was 6.29 rubles to the dollar.\textsuperscript{1007} By September 9, a little over three weeks later, the exchange rate reached 21 rubles to the dollar.\textsuperscript{1008} The Russian government’s inability to pay foreign investors in a timely fashion, coupled with the tumbling value of the ruble, sent shockwaves through the international economy, eliciting fears of currency devaluation in Asia. As one journalist noted, “The importance of events in Russia is that they are taking the world financial system yet closer to the edge, and the system is now so structured that losses in one country are transmitted to another.”\textsuperscript{1009} The Russian Default Crisis gave rise to a worldwide credit crunch, as frightened investors began to flee from riskier investments – like subprime mortgage-backed securities – and turned instead to safer ones.\textsuperscript{1010} Russia’s default also had a disastrous impact on Long-Term Capital Management.\textsuperscript{1011}

The hedge fund firm, Long-Term Capital Management, was founded in 1993 by a former bond trader at Salomon Brothers, John Meriwether.\textsuperscript{1012} In 1994, ten general partners of Long-Term Capital contributed $100 million to a hedge fund that bore the same name as the firm. That same year, the partners were able to raise an additional $3.1

\begin{thebibliography}{9}
\bibitem{1007} Ibid.
\bibitem{1008} Ibid.
\bibitem{1009} Will Hutton, “Russia’s Unplanned Revolution,” \textit{The Observer} (August 30, 1998).
\end{thebibliography}
billion in capital from outside investors.\textsuperscript{1013} From 1995 to 1997, the hedge fund generated impressive returns of 43\%, 41\%, and 17\%, respectively.\textsuperscript{1014} By December 31, 1997, Long-Term Capital borrowed $125 billion on capital of just $4.8 billion, essentially borrowing “$25 for every $1 of its equity capital.”\textsuperscript{1015} As Kathleen Day explains, “The fund used that borrowed money to place financial bets on financial instruments around the world. All told... the value of the fund’s contracts with other banks and investment firms gave the firm a derivatives exposure of $1.2 trillion.”\textsuperscript{1016} According to Michael Lewis, on August 17, 1998, the day that Russia defaulted on its debt, unreasonable fear swept through the world’s investing community to such an extent that the investment decisions made on that day gave rise to a completely unexpected scenario, one that had “a statistical probability” of occurring of “1 in 50 million.”\textsuperscript{1017} Not only did “the average investor” panic, the world’s “biggest financial firms” panicked as well, which created “a bank run on a huge, global scale.”\textsuperscript{1018}

On a single day, August 21, 1998, Long-Term Capital lost $550 million. By the end of August that year, the fund lost $2 billion of its invested $4.8 billion.\textsuperscript{1019} A few weeks later, on September 21, the fund lost over $500 million in a single day for the second time. It was not until two days later that “a consortium of 14 Wall Street banks and brokerage houses gave Long-Term [Capital] $3.6 billion, in exchange for 90 percent

\textsuperscript{1014} Ibid.
\textsuperscript{1016} Ibid., italics mine.
\textsuperscript{1017} Michael Lewis, “How the Eggheads Cracked.”
\textsuperscript{1018} Ibid.
\textsuperscript{1019} Ibid.

their name. One should note that, by the end of 2001, three more of those subprime lenders filed for bankruptcy protection, one ceased its subprime lending operations, and three were acquired by other companies.

Four deposit-taking institutions that had “significant involvement in subprime lending” also failed in the late-1990’s: BestBank, First National Bank of Keystone, Pacific Thrift and Loan Company, and Oceanmark Bank. At a February 8, 2000 hearing before the United States House of Representatives’ Committee on Banking and Financial Services, Chairman of the Federal Deposit Insurance Corporation, Donna Tanoue, testified that subprime lending without prudential lending standards was a leading cause of the failure of BestBank, First National Bank of Keystone, and Pacific Thrift and Loan

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These three bank failures cost the government a total of approximately $1 billion. At the same hearing, the Director of the Office of Thrift Supervision, Ellen Seidman, likewise noted that Oceanmark Bank’s “failed subprime lending strategy” was the primary reason behind its failure.

At one point during the hearing, Tanoue stated that subprime depository institutions were “twenty times more likely to become problem institutions” than prime lenders. Problem institutions are those that receive a 4 or 5 CAMELS rating on a scale of 1 to 5. The acronym “CAMELS” stands for the six aspects of a bank’s condition that are assessed by federal regulators: Capital adequacy, Asset quality, Management, Earnings, Liquidity, and Sensitivity to market risk. The higher a bank’s CAMELS rating, the more extreme is the level of supervisory concern. Tanoue added that subprime lenders represent nationally just over 1 percent of all insured deposit-taking institutions, but account for 20 percent of all problem institutions.

Chairman James Leach, reflecting upon the failures of the four deposit-taking institutions, astutely observed:

It strikes me that we are looking at a billion dollars in failure in the last year. These have been strikingly strong economic times, and these

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1036 Donna Tanoue, “Testimony on the Recent Bank Failures and Regulatory Initiative Before the United States House of Representatives’ Committee on Banking and Financial Services,” 17.
failures involve very small banks. So we have a billion dollars in failures in good times with very, very small banks, and so the question that seems to me particularly relevant is, in terms of coordination, do we not only have adequate coordination with small banks, but what about larger banks and what about situations where instruments at issue may be much more sophisticated?1037

Congressman Leach’s concern has proven to be hauntingly prescient. The subprime lending debacle at the end of the 1990’s was mostly confined to publicly traded non-depositories. Only four federally regulated depository institutions that were significantly involved in subprime lending failed during this time. What would happen if larger banks moved into subprime lending, creating “more sophisticated” subprime products? Was the federal regulation structure in place robust enough to oversee larger banks that had elected to participate in subprime lending? More generally, should there happen to be a severe economic downturn, one that would be even more serious than “The Panic of 1998,” how well would subprime lenders weather the storm?

Throughout 1998 and 1999, subprime mortgages were five times more likely to be delinquent than prime, conventional mortgages,1038 underscoring the pressing nature of these questions. Moreover, as disclosed by an April 5, 1999 report published by the Office of the Comptroller of the Currency (OCC), subprime lending was already “a target for many national banks.”1039 In this alarming report, the OCC revealed that competition by non-depositories in the prime lending market, the presence of additional funding that was made possible by securitization, and a “growing recognition of business

opportunities available in previously underserved or unserved markets” made subprime lending an attractive avenue for many banks.\footnote{1040}

The OCC also presented the results of their 1998 examination of national banks engaging in subprime lending. According to the report, the OCC examination “uncovered a number of serious weaknesses in the business and control processes used to manage the risks associated with [the national banks’] subprime lending activities.”\footnote{1041} These “deficiencies,” the report continued, “were more pronounced in two types of banks: those that knowingly engaged in subprime lending activities without an adequate understanding of the risks involved and those that unwittingly entered the market by relaxing underwriting standards or loosening credit-grading criteria in response to competition.”\footnote{1042} The OCC advised that national banks should not engage in subprime lending “without a clear understanding of the business and its inherent risks and a well-conceived business plan” because anything less exposes them to “unacceptable and unnecessary risk of loss.”\footnote{1043}

Even though the dangers of subprime lending became progressively apparent in the late 1990’s, a \textit{Commercial Lending Review} article published in the summer of 1999 revealed that approximately 150 deposit-taking institutions had “subprime portfolios exceeding 20\% of their capital.”\footnote{1044} After mentioning that those subprime portfolios had a total value of only $25 billion, the two authors of the article recall that deposit-taking institutions had “virtually no presence in the subprime market five years ago.”\footnote{1045}

\footnote{1040}Ibid. \footnote{1041}Ibid. \footnote{1042}Ibid. \footnote{1043}Ibid., 4. \footnote{1044}John H. Maher and Heather A. Allen, “Subprime Lending Draws Fire from Regulators,” \textit{Commercial Lending Review}, Vol. 15, No. 3, (Summer 2000). \footnote{1045}Ibid.
A few months later, in November of 1999, an article in National Mortgage News intimated that a “commercial bank invasion of the subprime sector” had been unleashed, a sector that had been “historically controlled by non-depositories.”\footnote{Paul Muolo, “Banks Take Over Subprime,” National Mortgage News, Vol. 24, No. 9, (November 15, 1999).} In the third quarter of 1999, five of the top ten, and ten of the top twenty-five subprime lenders were owned by commercial banks. These banks included Bank of America, Citigroup, New Century, Chase Manhattan, and Washington Mutual.\footnote{Ibid.} About six months later, at the end of the first quarter of 2000, eight of the top ten subprime lenders were commercial banks.\footnote{Robert Julavits, “Subprime Risks Extending Beyond Borrowers,” The American Banker, Vol. 165, No. 59, (March 27, 2000).}

Between 1993 and 1998, “the number of subprime mortgage loans originated by banks and thrifts” increased by 551%, while “the number of subprime loans originated by affiliates of banks and thrifts” increased nearly 7,000%.\footnote{United States Department of Housing and Urban Development, and the United States Treasury Department, “Curbing Predatory Home Mortgage Lending,” 45.} By the end of 1998, “banks, thrifts and their affiliates accounted for approximately one quarter of all subprime mortgage originations.”\footnote{Ibid.}

The aggressive entrance of commercial banks, thrifts, and their affiliates into the subprime sector at the end of the 1990’s and early 2000’s was an unusual development. Commercial banks and thrifts were, traditionally, “the staid elder statesmen of the financial world” that would charge “fair prices for a broad array of products,” while “keeping an arm’s length from overly trendy financial products.”\footnote{Lawrence Richter Quinn, “The Buying Up of Subprime,” Mortgage Banking, Vol. 58, No. 7, (April 1998).} Non-depositories, conversely, tended to “specialize in customers with credit problems, operating from


\footnote{1047 Ibid.}


\footnote{1049 United States Department of Housing and Urban Development, and the United States Treasury Department, “Curbing Predatory Home Mortgage Lending,” 45.}

\footnote{1050 Ibid.}

nondescript strip malls or with veteran sports celebrities as TV spokesmen” and would charge “higher rates to customers who could not qualify for loans from banks.” 1052 Historically, depositories and non-depositories “rarely crossed paths,” but the profit potential of subprime lending proved to be too enticing for the former to ignore. 1053 In the next chapter, I will discuss how large depositories and non-depositories alike flooded the subprime market, blinded by general bias, in some cases bolstered by group bias, eager to make immense sums of money even if it was at other people’s expense. It is to a consideration of the subprime lenders that I will now turn.

1052 Ibid.
1053 Ibid.
Chapter Three

3.0. The Lenders

3.1. Introduction

In this chapter, I will discuss how subprime lenders contributed to the subprime mortgage crisis. A central part of my argument is that the largest subprime lenders were the beneficiaries, at least in the short-term, of an inadequate regulatory apparatus. This chapter will chronicle two distinct failures: the failure of lenders to resist the temptation to recklessly engage in myopic profit-seeking behaviors, and the failure of regulators to curtail those behaviors in a timely fashion.

In order to bring clarity to this discussion, I will identify the ten different types of mortgage lenders and underscore the six types of lenders that will be explored in this chapter. I will then establish how an inadequate, fragmented regulatory framework was in place that was not suitable for overseeing large, diverse, and complicated lenders. Since this piecemeal regulatory framework is predicated on differences in types of lenders, I will explore whether thrifts, national banks, and non-depository mortgage lending subsidiaries are legitimately distinct enough to warrant this regulatory arrangement. Next, I will peruse different estimates of how involved each type of lender was in the subprime market. Once this background information is established, I will provide a survey of preconditions that made the subprime lending boom possible. Of these preconditions, the invention of securitization was particularly crucial. Deregulatory preconditions will also be investigated, including the ever-important federal preemption of state consumer protection laws. I will argue that these laws created a consumer protection void for
borrowers that the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS) were unable or unwilling to fill before the subprime crisis. I will then raise the question of how well the OCC and OTS were able to ensure the safety and soundness of their regulated lenders. To answer that question, I will provide a snapshot of the OCC’s regulatory relationship with Wells Fargo Home Mortgage and Chase Home Finance, and then a longer, more detailed account of the OTS’ relationship with one of its regulated lenders, Washington Mutual.

After providing a summary assessment of the work of those two regulators, I will turn to a third federal regulator, the Federal Reserve. I will point out how the Federal Reserve had the authority to prohibit unfair and deceptive lending practices, but it refused to do so until July 30, 2008. I will examine the Federal Reserve’s regulatory posture toward non-depository mortgage lending affiliates and then provide a brief examination of one of its regulated lenders, Countrywide Home Loans. The final portion of this chapter will consist of an examination of the relationship between non-depository independent mortgage lenders and state regulators. The evidence suggests that the vast majority of the individual state regulators were underfunded and ill-equipped for overseeing large non-depository independent mortgage lenders, such as Ameriquest and New Century Financial.
3.2. The Ten Different Types of Mortgage Lenders

Mortgage banking regulation in the United States is both complicated and fragmented. There are four main federal mortgage banking regulators, each of which has “jurisdiction over a different type of [mortgage] lender,” in addition to fifty state regulators. In a 2008 report, The United States Department of the Treasury observed that the “jurisdictional boundaries” among the four regulators “often blur” and their responsibilities “significantly overlap.”

The coexistence of federal and state banking regulators in the United States, known as “the dual banking system,” has been justified on the grounds that competition between the two types of regulators fosters innovation and reduces “unnecessary and burdensome regulations” for lenders. As I agree with the claim that “[t]he subprime crisis was the direct result of not policing the market,” it is necessary to examine this assumption, as well as identify which regulator oversaw each sort of mortgage lender. Furthermore, I will explore each regulator/lender relationship and, by way of presenting

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1054 These federal regulators are: The Federal Reserve Board (Fed), The Office of the Comptroller of the Currency (OCC), The Office of Thrift Supervision (OTS), and The Federal Deposit Insurance Corporation (FDIC). A fifth federal banking regulator, The National Credit Union Administration (NCUA), is not included in this discussion due to the fact that credit unions were not heavily involved in subprime mortgage lending. At the end of 2007, there were 8,101 federally insured credit unions, which included over 98% of all of the credit unions in the United States. Of those 8,101 credit unions, less than 6% of them offered what NCUA Chairman Joann Johnson called “nontraditional mortgages,” and those mortgages represented just over 2% of all of their mortgages outstanding. Please see: Joann M. Johnson, “Condition of the Banking Industry: Testimony Before the United States Senate Committee on Banking, Housing, and Urban Affairs,” (March 4, 2008), available at http://www.ncua.gov/newspublications/news/speeches/2008/StateOfIndustry-ChairmanJohnson.pdf.

1055 Kathleen C. Engel and Patricia A. McCoy, Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps (Oxford: Oxford University, 2011), 152.


the losses endured by a few of the largest subprime lenders, I will argue that the federal and state regulatory oversight was entirely inadequate prior to the outbreak of the subprime mortgage crisis.

Broadly speaking, there are two types of mortgage lenders: depository institutions and non-depository institutions. Depository institutions accept deposits from customers, while non-depository institutions typically fund their lending activities by borrowing money from commercial or investment banks.\textsuperscript{1059} The source of funding for extending credit to the public, therefore, determines whether a lender is classified as a depository or non-depository.

Within the category of depositories, there is a further distinction, one that hinges on the depository’s charter.\textsuperscript{1060} If a depository chooses to receive a federal charter under the National Bank Act (passed in 1864), it is known as a national bank and the OCC serves as its regulator. One can “usually recognize a national bank because the word National appears in its name or the term National Association (N.A.) is at the end.”\textsuperscript{1061} As of February 28, 2011, there were 1441 national banks in the United States.\textsuperscript{1062}

A depository could also elect to receive a charter under The Home Owners Loan Act (passed in 1933), which would designate it a federally chartered thrift institution. Thrifts are supervised by The Office of Thrift Supervision (OTS) and frequently have the


\textsuperscript{1060} A charter is a license that permits a given organization to engage in certain specified activities.

\textsuperscript{1061} \textit{The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps}, 151.

word “Federal” in their name.\textsuperscript{1063} As of March 31, 2010, the OTS was regulating 757 thrifts.\textsuperscript{1064}

A third option for depositories is to choose to receive a charter from one of the fifty state bank commissions. Depositories opting to be chartered by a state are known as state national banks or state thrifts.\textsuperscript{1065} State-chartered national banks have the further option of choosing to be a member of the Federal Reserve System. If a state-chartered national bank is part of this system, it is known as a state member bank and is regulated by the Federal Reserve Board (Fed) as well as by its state regulator. Conversely, if a state-chartered bank is not part of the system, it is called a state nonmember bank and is regulated by The Federal Deposit Insurance Corporation (FDIC) and its state regulator. State-chartered thrifts do not have the option of being part of the Federal Reserve System and they are regulated by the OTS and their state regulator.\textsuperscript{1066}

So far, then, there are five types of depository lenders: (1) federally-chartered national banks (regulated by the OCC), (2) federally-chartered thrifts (regulated by the OTS), (3) state-chartered member national banks (regulated by the Fed and a state regulator), (4) state-charted nonmember national banks (regulated by the FDIC and a state regulator), and (5) state-chartered thrifts (regulated by the OTS and a state regulator). Assuming that a depository can meet certain requirements, which vary for each regulator, it can choose its charter and, consequently, its regulator. Of these types of depositories, only federally chartered national banks and thrifts will be discussed in this study.

\textsuperscript{1063} The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps, 151-152.
\textsuperscript{1064} This information is available at the OTS homepage, http://www.ots.treas.gov.
\textsuperscript{1065} The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps, 152.
\textsuperscript{1066} Ibid., 152-153.
The regulatory landscape for non-depositories is, likewise, complex and fragmented. There are five different kinds of non-depository lenders. First, there are non-depository mortgage lending subsidiaries of national banks (6) that are regulated by the OCC, while there are also non-depository mortgage lending subsidiaries of thrifts (7) that are regulated by the OTS. Subsidiaries in this case are owned by the parent national bank or thrift. For instance, JPMorgan Chase Bank, N.A., a national bank, owns a non-depository mortgage lending subsidiary named Chase Home Finance, both of which are regulated by the OCC. Before it failed, Independent National Mortgage Bancorp (IndyMac), a thrift, owned a non-depository mortgage lending subsidiary called IndyMac Bank, both of which were regulated by the OTS. Non-depository mortgage lending subsidiaries share the same regulator as their parent national bank or thrift.1067

Second, there are non-depository mortgage lending affiliates (8) that are regulated by the Fed and there are non-depository mortgage lending affiliates (9) that are regulated by the OTS. In this case, an affiliate’s regulator is determined by the sort of holding company to which it belongs. Non-depository mortgage lending affiliates that belong to a bank or financial holding company are regulated by the Fed, while those that belong to a savings and loan holding company are regulated by the OTS.1068 In this study, only non-depository mortgage lending affiliates that belong to bank or financial holding companies will be examined.

Finally, there are non-depository independent mortgage lenders (10) that are supervised by a state regulator.1069 These lenders are “independent” by way of being neither affiliates nor subsidiaries of national banks and thrifts within a holding

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1067 Ibid., 170-177.
1068 Ibid., 153.
1069 Ibid.
company. They are independent of the holding company structure. Two of the largest non-depository independent mortgage lenders prior to the outbreak of the subprime mortgage crisis were New Century Financial Corporation and Ameriquest Mortgage. I will examine both of these lenders in a later section.

In this study, I am going to focus on six of these ten types of lenders since they were responsible for the majority of subprime loan originations leading up to the collapse of the housing market. These six lenders are: (1) federally chartered national banks, (6) non-depository mortgage lending subsidiaries of national banks, (2) federally chartered thrifts, (7) non-depository mortgage lending subsidiaries of thrifts, (8) non-depository mortgage lending affiliates that are part of a bank or financial holding company, and (10) non-depository independent mortgage lenders. As I will mention below, non-depository mortgage lending subsidiaries’ assets and liabilities are, for accounting and regulatory reporting purposes, indistinguishable from those of their parent national bank or thrift. Consequently, unless otherwise noted, when I speak of a federally chartered national bank (1) or thrift (2), I am also tacitly referring to its operating subsidiaries (6, 7) as well. State-chartered member (3) and nonmember national banks (4), state-chartered thrifts (5), and non-depository mortgage lending affiliates belonging to a thrift holding company (9) are not going to be examined in this study. Figures 1 through 3 summarize this complex regulatory arrangement.

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1071 The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps, 205.
Figure 1

Bank/Financial Holding Companies (Regulated by the Fed)

(1) Federally Chartered National Banks (Regulated by the OCC)

(6) Non-Depository Mortgage Lending Subsidiaries of National Banks (Regulated by the OCC)

(3, 4) State Chartered Member/Non-Member Banks (Regulated by the Fed or FDIC and a state regulator)

(8) Non-depository Mortgage Lending Affiliates (Regulated by the Fed)

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Figure 2

Thrift Holding Companies
(Regulated by the OTS)

(2) Federally Chartered Thrifts
(Regulated by the OTS)

(7) Non-Depository Mortgage Lending Subsidiaries of Thrifts
(Regulated by the OTS)

(5) State Chartered Thrifts
(Regulated by the OTS and a state regulator)

(9) Non-depository Mortgage Lending Affiliates (Regulated by the OTS)

Figure 3

(10) Non-depository Independent Mortgage Lenders
(Regulated by a state regulator)
3.3. Why This Fragmented Regulatory Framework Was In hospitable to Effective, Timely Oversight of Subprime Mortgage Lenders

The piecemeal nature of mortgage banking regulation in the United States, along with the daunting number of types of mortgage lenders, was “a matter of historical accident and definitely not planning.”¹⁰⁷³ For the purposes of this study, one of the most important reasons why mortgage banking regulation became so fragmented and sophisticated was the existence of bank and, later, financial holding companies.¹⁰⁷⁴ A bank holding company is “a corporation that holds stock in one or more banks and other financial service organizations.”¹⁰⁷⁵ They are umbrella organizations that envelope national banks and other firms that are involved in federally approved activities that happen to be “closely related” to banking, such as “making and servicing loans, conducting certain leasing activities, [and] providing investment and financial advice.”¹⁰⁷⁶ The bank holding company structure gives the parent corporation several real advantages, including “flexibility of management, improved access to financial resources, and greater freedom from state and federal restrictions on the scope of activities of banks and geographic location of banking offices.”¹⁰⁷⁷

Up until 1994, bank holding companies that were “headquartered in one state could not acquire banks in other states,” but that restriction was removed under the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994.¹⁰⁷⁸ Another

¹⁰⁷³ Ibid., 152.
¹⁰⁷⁴ There are also thrift holding companies, but since they and their holdings are all regulated by the OTS, I did not include them in this discussion.
¹⁰⁷⁶ Ibid.
¹⁰⁷⁸ Commercial Banking: The Management of Risk, 45.
watershed moment for banking holding companies was the passing of the Gramm-Leach-Bliley Act of 1999 (GLBA). GLBA created financial holding companies, entities that are permitted to “engage in a wide range of financial activities including underwriting and selling insurance and securities, commercial and merchant banking, [and] investing in and developing real estate.” GLBA authorized the Fed to serve as the principle regulator of financial holding companies. Unfortunately, as I will discuss later, GLBA never designated the Fed as the enforcer of its regulations for non-depository mortgage lending affiliates within a bank or financial holding company, an oversight that led to an enormous regulatory blind-spot that permitted certain large lenders, like Countrywide Home Loans, to recklessly originate hundreds of billions of dollars worth of risky mortgages.

The bank and financial holding company structure, along with their permitted activities, pose substantial challenges to federal and state regulators. This is especially true because holding companies “reorganize their holdings on a relatively frequent

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1079 Ibid., 43.
1081 Mortgage banking is only one part of the financial services industry, which includes other sectors like securities, futures, and insurance. As a United States Government Accountability Office (GAO) report explains, the responsibilities for “overseeing the financial services industry are shared among almost a dozen federal banking, securities, futures, and other regulatory agencies, numerous self-regulatory organizations, and hundreds of state financial regulatory agencies.” In this dissertation, the concerns that I raise about the adequacy of federal regulation are limited to the oversight of mortgage lenders that engaged in subprime lending. However, as the same GAO report argues, financial regulation in general has become “outdated” in the United States because it “has not kept pace with the major developments that have occurred in financial markets and products in recent decades.” I would contend that the existence of financial holding companies lends credence to this assertion. Please see: The United States Government Accountability Office, “Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System,” Report to Congressional Addressees (January 2009), available at http://www.gao.gov/new.items/d09216.pdf, 1.
In an effort to examine the challenges that pertain to this article, I will briefly and partially dissect Bank of America Corporation, the largest financial holding company as of December 31, 2010.

Worldwide, Bank of America Corporation is the parent of an astonishing 3,075 firms ranging from other holding companies, national banks, industrial banks, insurance companies, non-depository trust companies and other types of organizations. Altogether, the corporation has over $2.2 trillion worth of assets. Bank of America published a truncated organizational tree diagram of the corporation, one that only included “select” firms as of December 31, 2010. Perusing just this trimmed down representation of the corporation reveals that it houses 23 holding companies and 17 “major operating subsidiaries.” Thus, a financial holding company can house other holding companies.

As a financial holding company, Bank of America Corporation is regulated by the Fed. Yet, one of its holdings is Bank of America, N.A., a national bank. As such, the OCC is its regulator. Bank of America, N.A., has seven operating subsidiaries of its own, including Nexstar Financial Corporation, CWB Mortgage Ventures, and Independence One Mortgage Corporation. These are non-depository mortgage lending subsidiaries of a national bank, which means that they, too, are regulated by the OCC. Finally, an affiliate of Bank of America Corporation is Countrywide Home Loans, Inc. As a non-

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depository mortgage lending affiliate within a financial holding company, Countrywide is regulated by the Fed.

These observations are not intended to serve as a thorough analysis of Bank of America’s corporate structure. Rather, their purpose is to underscore the elaborate nature of the structure as well as the regulatory obstacles that it presents. A bank or financial holding company can house different types of mortgage lenders with names that are distinct from one another and their parent, while being simultaneously supervised by different regulators. As Sheila Bair stated in January of 2010, “The increasing size, span, and complexity of financial institutions have… made regulation and supervision remarkably difficult.”

On top of this difficulty, federal regulators were further challenged by having to adopt a “silo approach” to mortgage banking regulation after GLBA was passed in 1999. The “silo approach” to federal regulation legally “wedged” the different federal regulators into different silos, “keeping each regulator’s silo off limits to other regulators.” As “the super-regulator of financial holding companies” under GLBA, one may be tempted to assume that the Fed was authorized to oversee all of the firms contained within a given holding company, not just the parent corporation and its non-depository mortgage lending affiliates. Perhaps true in theory, this was clearly not the case in practice. Congress told the Fed to rely upon “bank and thrift examination reports by other state and federal banking regulators to the fullest extent possible” instead of

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1087 The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps, 204.
1088 Ibid.
1089 Ibid.
examining “those banks and thrifts itself.” 1090 This created a “catch-22” situation in the sense that the Fed needed to make a case that certain lenders were posing risks to the financial system before they could get access to the very reports that could confirm that these companies were, in fact, posing those risks. 1091 One could make the case that federal regulation of depositary and non-depository mortgage lenders was plagued by “too many consonants” and “not enough consonance.” 1092

Returning to the discussion of Bank of America Corporation’s structure may be helpful here. GLBA authorized the Fed to directly oversee the financial holding company, Bank of America Corporation. Imagine, however, that there were allegations that Bank of America, N.A. or one of its operating subsidiaries (such as Nexstar) was involved in predatory or otherwise unsafe lending practices. In this hypothetical scenario, the Fed would not be able to directly obtain the information it needed to assess the risks that Bank of America, N.A. or its operating subsidiaries were creating. Instead, the Fed would have to rely upon examination reports issued by the OCC. This places a considerable burden on the OCC to conduct timely, rigorous, and effective examinations of the accused lender. I will argue in a later section that the OCC (as well as the OTS) were unable or unwilling to conduct such examinations on many of their chartered lenders that were participating in subprime lending. I will also contend that the Fed was unwilling to oversee non-depository mortgage lending affiliates that were part of bank or

1090 Ibid.
1091 Sheila Bair, Chairman of the FDIC, made a similar point in a different context when she claimed that the OTS resisted efforts by the FDIC to examine the ailing thrift holding company, Washington Mutual, before its collapse. The FDIC was the so-called secondary regulator of Washington Mutual, while the OTS was its primary regulator. Please see: The United States Senate Permanent Subcommittee on Investigations, “Hearing on Wall Street and the Financial Crisis: The Role of Bank Regulators,” (April 16, 2010), available at http://www.gpo.gov/fdsys/pkg/CHRG-111shrg57320/html/CHRG-111shrg57320.htm.
financial holding companies, a type of lender that was similarly “off limits” to the oversight of the OCC, OTS, and the states.

For now, the crucial point is that this regulatory arrangement “allowed federal regulators to slough off moral responsibility for their contribution to the crisis.”\textsuperscript{1093} In the absence of a concerted federal regulation effort, each federal regulator could “shrug” at the subprime regulatory lapses of their counterparts.\textsuperscript{1094} In addition to being responsible for overseeing different parts of an extraordinarily large and diverse type of corporation (whether a bank, thrift, or financial holding company, along with any combination of affiliates, national banks, thrifts, and operating subsidiaries), the federal regulators were obligated to attempt to regulate these firms in their own “silos.” It is highly questionable whether compartmentalized regulation, which made possible a diffusion of regulatory responsibility, was the most effective approach to supervising corporations as large and diverse as bank and financial holding companies.

3.4. Why Is There a Distinction Between Thrifts and National Banks?

One may wonder why there is a distinction between thrifts and national banks, upon which the distinction between OTS-regulated lenders and OCC-regulated lenders is predicated. Are thrifts so different from national banks that they warrant a completely separate federal regulator? In order to adequately answer this question, it will be helpful to explore part of the history of the OTS.

The Office of Thrift Supervision (OTS) was created by Congress in 1989. In response to a growing dissatisfaction with the state of the thrift industry during the

\textsuperscript{1093} Ibid.
\textsuperscript{1094} Ibid.
Savings and Loan Crisis, Congress passed the Financial Institutions Reform, Recovery and Enforcement Act of 1989, which supplanted the Federal Home Loan Bank Board, the previous federal regulator of thrifts, with the OTS.\textsuperscript{1095} The year that Congress founded the OTS, there were over 3,000 chartered thrifts.\textsuperscript{1096}

Historically, thrifts were unique financial institutions because unlike national banks, which also had their own regulator (the OCC) and charter, the former additionally had their own lending requirements.\textsuperscript{1097} In order to be chartered as a federal thrift, a financial institution had to meet the qualified thrift lender (QTL) test, which required it to “devote 65% of its business to originating mortgages and some other forms of consumer debt” including student and credit card loans.\textsuperscript{1098} The authors of a 2009 paper published by The Center for Responsible Lending noted that this federally mandated concentration in residential lending made thrifts particularly “vulnerable to the housing market’s historical boom-and-bust cycle,” for it inhibited “their ability to diversify their loan portfolios.”\textsuperscript{1099} At the end of 2002, for example, residential mortgages comprised 67.5 percent of thrift assets compared to only 27.3 percent of national banks’ assets.\textsuperscript{1100}

Perhaps in an effort to help federally chartered thrifts reach their homeownership-centered lending goals, Congress granted them a number of significant privileges. For the sake of brevity, I will only examine two of them. First, the Home Owners Loan Act


\textsuperscript{1098} Ibid.


\textsuperscript{1100} \textit{The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps}, 175.
(HOLA), enacted by Congress in 1933, preempted state anti-branching laws for federally chartered thrifts. Previously, these anti-branching laws prohibited depositories from branching across state lines. HOLA permitted federally chartered thrifts to participate in interstate branching, but it did not confer the same benefit to national banks. Financial institutions that were “interested in building a national market of retail depositors were incentivized to choose thrift charters, which permitted interstate branching,” over national bank charters.

Second, HOLA endowed thrifts with “strong federal preemption powers” that were “less obviously” granted to national banks. HOLA provided for “the plenary and exclusive authority of the [OTS] to regulate all aspects of the operations of Federal savings associations… This exercise of the Office's authority is preemptive of any state law purporting to address the subject of the operations of a Federal savings association.” The obvious advantage of this expansive federal preemption was that thrifts enjoyed less state supervision than national banks. Federally chartered national banks, under the National Banking Act of 1864, also enjoyed federal preemption of state laws, but only in those instances when the federal laws conflicted with the state laws. Thus, the scope of federal preemption was broader for federally chartered thrifts than it was for federally chartered national banks.

The reason for mentioning these privileges, along with the aforementioned thrift lending requirements, is to provide at least a partial justification for the charter and

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1102 Ibid.
1103 Ibid., 14.
1104 Ibid. Italics mine. 12 C.F.R. § 545.2.
1105 Ibid.
1106 Ibid.
regulator-based distinction between federal thrifts and national banks. One could argue that the regulatory environment for thrifts differs from that of national banks to the extent that the two types of lenders needed to have different federal regulators. Acknowledging that there were 3,000 chartered thrifts in 1989, one could maintain that Congress’ decision to create a new federal regulator, one that could be especially responsive to the needs of thrifts, was a reasonable one. Having two different federal regulators overseeing depositories going into the 1990’s was, therefore, an understandable situation.

However much merit this argument has, one should note that the marked distinctions between federally chartered thrifts and national banks began to collapse shortly after the creation of the OTS in 1989. Just five years after the advent of the OTS, Congress passed the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, which “amended the limitations on interstate branching by [national] banks, making such branching essentially as easy as branching via thrifts.”1107 National banks could now “open interstate branches without having to create a separate banking corporation in each state.”1108 In this sense, national banks came to resemble more closely federally chartered thrifts.

Interestingly, perhaps in response to the diminished value of their interstate branching privileges, the OTS finalized “sweeping” preemption regulations in 1996.1109 First, the OTS put forth a rule in the fall of that year that asserted that “with certain narrow exceptions, any state laws that purport to affect the lending operations of federal

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1107 Ibid., 16.
savings associations are preempted.”¹¹¹⁰ Then, a few months later, the OTS issued another rule that concluded that “state law is preempted for [thrift] operating subsidiaries to the same extent that it is for the parent federal savings association… because an operating subsidiary is treated as the equivalent of a department of the federal thrift for regulatory and reporting purposes.”¹¹¹¹

This was a pivotal moment in federal and state mortgage banking regulation history because non-depository mortgage lending operating subsidiaries of thrifts were “creatures of state law,” devoid of a federal charter. The regulations issued by the OTS in late 1996 suddenly dictated that operating subsidiaries of thrifts could “ignore state law” to the same extent as their thrift parents.¹¹¹² Importantly, as subprime lending-related abuses became more and more prevalent in the late 1990’s, individual states began issuing anti-predatory lending laws to protect their citizens. The 1996 OTS regulations predated many of these and other consumer protection laws and eventually permitted federally chartered thrifts and their operating subsidiaries to uniformly disregard them.¹¹¹³ In order to draw out the importance of this development, it will be useful to explain both what non-depository mortgage lending operating subsidiaries are, as well as why they exist in the first place.

¹¹¹² National Consumer Law Center, “Preemption and Regulatory Reform: Restore the States’ Role as ‘First Responder’,” 9.
¹¹¹³ Patricia A. McCoy and Elizabeth Renuart, “The Legal Infrastructure of Subprime and Nontraditional Home Mortgages,” 12.
3.5. What Are Non-Depository Mortgage Lending Subsidiaries?

On the surface, non-depository mortgage lending operating subsidiaries of federally chartered thrifts and national banks are peculiar entities. One may wonder why they exist in the first place since federally chartered thrifts and national banks can originate mortgages themselves. These operating subsidiaries are permitted to “engage in virtually the same scope of activities” that are permissible for their federally chartered parents, with the obvious exception of taking deposits.1114 Significantly, since they do not accept deposits, however, non-depository operating subsidiaries are not “subject to the safety and soundness regulations” that are applicable to their parent depository, such as capital requirements.1115 In fact, non-depository mortgage lending operating subsidiaries enjoy a number of regulatory advantages that are not available to depository parents.1116 An example of one of these advantages is that they can “obtain unlimited funds from parent banks on terms and conditions [that are] favorable to the operating subsidiaries” themselves.1117

Still, a non-depository mortgage lending operating subsidiary resembles its parent so closely that, for accounting and regulatory reporting purposes, the former’s assets and liabilities are indistinguishable from the latter’s.1118 In terms of determining “their power and status under Federal law,” the courts “have consistently treated operating subsidiaries

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1115 Ibid., 283.
1116 Ibid., 283-284.
1117 Ibid., 284.
1118 Ibid., 296.
as equivalent to national banks” and thrifts.\textsuperscript{1119} In essence, non-depository operating subsidiaries are “no more than incorporated departments” of their parent thrift or national bank.\textsuperscript{1120}

Despite all of these striking similarities, non-depository operating subsidiaries differ from their parent federally chartered thrift or national bank in at least one more crucial respect: they have a separate legal status as state-chartered corporations.\textsuperscript{1121} Several important implications follow from the legal separation that accompanies the parent-operating subsidiary relationship. First, since non-depository operating subsidiaries are legally distinct entities from their parents, “the fundamental principles of corporate law that limit liability” apply to the relationship.\textsuperscript{1122} In other words, in the event that one of its operating subsidiaries fails, the parent depository’s losses can potentially be limited to its investment in the subsidiary. As a November 27, 1996 entry in the Federal Register notes, “the use of a separate subsidiary structure can enhance the safety and soundness of conducting new activities by distinguishing the subsidiary’s activities from those of the parent bank.”\textsuperscript{1123} A second benefit of the parent-subsidiary relationship then, in addition to the one involving certain funding advantages for the subsidiary, is that it can promote safety and soundness. Should a non-depository operating subsidiary become insolvent, the parent company could potentially be shielded from any of its “child’s” liabilities.

Additionally, since a federally chartered parent thrift or national bank is legally distinct from its non-depository operating subsidiaries, they are required to either have

\textsuperscript{1119} Ibid. Italics mine.
\textsuperscript{1120} Ibid.
\textsuperscript{1121} Ibid., 295.
\textsuperscript{1122} Ibid.
\textsuperscript{1123} Ibid., 305. Please see: 61 Fed. Reg. at 60,354.
different names or, should they have similar names, they must take “appropriate steps to minimize the risk of customer confusion.” 1124 As Wookbai Kim astutely notes, this requirement distances the parent national bank or thrift from the business operations of its operating subsidiaries in the eyes of the public. The parent company can outsource unseemly, though profitable, lending activities to its operating subsidiaries, while protecting itself from reputational damage that could result from those activities. 1125 This arrangement enables the parent to appear to the public as the “good depository,” whileopaquely funding and receiving some of the profits from the operations of its “bad non-depository subsidiary.”

An excellent example of federally chartered depositories minimizing reputational threats and preserving its safety and soundness by outsourcing part of its subprime operations to a subsidiary can be discerned in the case of National City Bank, N.A. (a federally chartered national bank), Merrill Lynch & Trust Co., FSB (a federally chartered thrift), and First Franklin Financial Corporation (a non-depository operating subsidiary). In late 2006, well after analysts and officials had begun “ringing warning bells about exotic mortgages” and housing data indicated that the risks associated with subprime mortgages was rising, Merrill Lynch, an arranger, announced that they would purchase First Franklin from its parent, National City, for $1.3 billion. 1126

First Franklin was a trailblazer in the subprime lending industry. They were one of the first subprime lenders to issue interest-only mortgages, which enabled borrowers to

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avoid paying any of their mortgage loans’ principal for a certain period of time.\textsuperscript{1127} They were also heavily “into low-doc and no-doc loans.”\textsuperscript{1128} Published reports indicate that First Franklin was originating more than 650 subprime loans a day to consumers in 2005.\textsuperscript{1129} By 2006, they were the eighth largest subprime lender in the country.\textsuperscript{1130}

For roughly the previous seven years, from 1999-2006, First Franklin was a non-depository operating subsidiary of National City. Part of the reasoning behind Merrill Lynch’s decision to purchase First Franklin in late 2006 was that the latter provided the former with “a cheaper and more direct path to reaping the proceeds of [subprime] securitization.”\textsuperscript{1131} Merrill Lynch apparently had some reservations about their purchase, however, because they required National City to “retain $10 billion of First Franklin’s old ‘non-prime’ loans,” a provision that eventually contributed to National City’s demise in 2008.\textsuperscript{1132} Shortly after the transaction was completed, then-President and CEO of First Franklin, L. Andrew Pollock, testified in front of the Senate Committee on Banking, Housing, and Urban Affairs, affirming that his company employs “underwriting standards that assure the quality” of the loans that they originate and that those standards are “designed to ensure that borrowers can afford to repay the mortgages” that they originate, both currently and in recent years.\textsuperscript{1133}

\textsuperscript{1127} Ibid.
\textsuperscript{1128} \textit{The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps}, 169.
\textsuperscript{1130} \textit{The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps}, 205.
\textsuperscript{1131} Allison Pyburn, “Merrill Lynch to Boost HEL ABS Business with First Franklin Buy,” \textit{Asset Securitization Report} (September 11, 2006).
\textsuperscript{1132} \textit{The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps}, 169.
Merrill Lynch’s concerns about the quality of First Franklin’s past subprime loan originations turned out to be well-founded. Within months after their purchase, it eliminated First Franklin’s line of 2/28 subprime loan offerings due to the product’s excessive risk.\(^{1134}\) By the end of the first half of 2007, First Franklin posted losses of $111 million.\(^{1135}\) On March 5, 2008, Merrill Lynch publicly announced that First Franklin would cease originating mortgages altogether.\(^{1136}\)

Later that year, the OCC published a report in November titled “The Worst Ten in the Worst Ten,” which referred to the top ten metropolitan areas “experiencing the highest rates of foreclosure” coupled with the top ten subprime originators who had experienced the largest number of subprime mortgage foreclosures in each of those areas.\(^{1137}\) First Franklin was one of only four companies that qualified as being a “Worst Ten” originator in all ten of the metropolitan areas that were hit the hardest by subprime mortgage foreclosures in 2008. Nearly a year and a half later, in March of 2010, the OCC repeated its study and discovered that, once again, First Franklin was a “Worst Ten” originator in all ten metropolitan areas that endured the most subprime mortgage foreclosures, this time over the course of 2009.\(^{1138}\) In a 2009 report, The Center for Public Integrity noted that in just three years, from 2005 to 2007, First Franklin was responsible

for originating over $68 billion worth of subprime loans, earning it a ranking of the fourth largest subprime lender over that period of time.\textsuperscript{1139}

The important point is that the parent-operating subsidiary relationship can mislead the general public into thinking that the operating subsidiary is entirely distinct from and unrelated to its parent. Originating subprime mortgage loans without “reviewing the borrowers’ repayment ability” and then foreclosing on their homes would ordinarily impair the reputations of all parties involved, leaving them vulnerable to “litigations, financial loss, or a decline in their customer base.”\textsuperscript{1140} However, when the operating subsidiary acts in irresponsible ways, the parent-operating subsidiary relationship tends to deflect attention and legal culpability away from the parent and, instead, invites the public to exclusively place blame on the operating subsidiary.

For instance, in March of 2006, Marielite Hardy, a lab assistant from Revere, Massachusetts, received $670,000 in loans from First Franklin to purchase a multi-family home. First Franklin approved her loan application, which listed her monthly income as $12,000, and then sold the first loan on the property to the London-based bank HSBC. Hardy did not make a single payment on the mortgage, so HSBC demanded that First Franklin buy the loan back from them. First Franklin agreed and ultimately sold the loan in a distressed sale, absorbing a $295,908 loss. Soon after these events, it surfaced that Hardy’s income was overstated by about $9,000 a month on her loan application.\textsuperscript{1141}

Regardless of whether this is an exceptional example, the point that I would like to emphasize is that First Franklin’s parent company at the time, National City, was

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\textsuperscript{1139} The Center for Public Integrity, \textit{Who’s Behind the Financial Meltdown: The Top 25 Subprime Lenders and Their Wall Street Backers} (May 2009), 14.
\textsuperscript{1140} Wookbai Kim, “A Study on How Regulatory Capture Caused the Subprime Mortgage Crisis and What to Do for Robust Consumer Protection,” (December 2009), 58.
\end{flushleft}
completely absent from the media coverage of the story. Similarly, in September of 2007, when the National Association for the Advancement of Colored People (NAACP) filed a lawsuit against First Franklin and ten other mortgage lenders for “singling out African-Americans for costly subprime loans,” First Franklin’s parent at the time, Merrill Lynch, was not listed as one of the accused.1142

As separate legal entities, parent companies can use their resources in assisting non-depository subsidiaries to take risks, without having to attach their name, image, financial health, or reputation to those risks. In short, the parent-operating subsidiary relationship encourages the perception that the parent plays no part in the subprime lending activities of its operating subsidiary. It provides legal, financial, and reputational protections to the parent, shielding it, at least to some extent, from the negative consequences that could accompany subprime lending operations. As Ronald Silverman notes, this curious relationship enabled parent depositories to participate in the subprime mortgage market in a “veiled capacity.”1143 Keeping this discussion of non-depository operating subsidiaries in mind, one can be in a better position to understand the serious consequences that eventually resulted from the widespread federal preemption of state consumer protection laws that occurred in the early 2000’s. As I will discuss below, federally chartered thrifts and national banks as well as their non-depository operating subsidiaries enjoyed federal preemption privileges.

3.6. How Involved Was Each Type of Lender in the Subprime Mortgage Market?

Pinning down the precise amounts of subprime mortgage loans originated by each type of lender in the early 2000’s is a formidable task mainly because of the absence of a federally-recognized definition of the term “subprime.” Nevertheless, at least two different organizations, the Fed and the OCC, attempted to determine the extent to which national banks, thrifts, their non-depository operating subsidiaries, non-depository mortgage lending affiliates of holding companies, and independent lenders were involved in subprime lending at that time. Both sets of findings are worth exploring.

Let us begin with the Fed. In their December of 2010 report, “The 2009 HDMA Data: The Mortgage Market in a Time of Low Interest Rates and Economic Distress,” they looked at the amount of “higher-priced” loans that were originated by each type of lender from 2006 to 2009.1144 Non-depository, independent, state-regulated mortgage lenders originated 45.7% of higher-priced loans in 2006, 21.1% in 2007, 18.2% in 2008, and 20.8% in 2009.1145 Depositories, including national banks and thrifts, originated 28.4% of higher-priced loans in 2006, 45.3% in 2007, 60.8% in 2008, and 70.6% in 2009.1146 Finally, non-depository mortgage lending affiliates of holding companies, along with non-depository subsidiaries of national banks and thrifts, originated 25.9% of

1145 Ibid., A65.
1146 Ibid.
higher-priced loans in 2006, 33.6% in 2007, 21.0% in 2008, and 8.6% in 2009.\textsuperscript{1147} Over that four year span, non-depository independent mortgage companies originated 1,791,462 higher-priced loans (33.9% of the total), national banks and thrifts originated 2,107,087 higher-priced loans (39.8% of the total), and non-depository subsidiaries and non-depository mortgage lending affiliates originated 1,390,118 higher-priced loans (26.3% of the total).\textsuperscript{1148} Figures 4 and 5 summarize the Fed’s findings.

Figure 4: Yearly Percentage of Higher-Priced Loans Originated By Each Type of Mortgage Lender from 2006-2009

\textsuperscript{1147} Ibid.
\textsuperscript{1148} Ibid.
The OCC, for its part, “acquired a database developed and marketed by Loan Performance Corp.,” which it claims is “the premier data source on nonprime (that is, both subprime or B/C and Alt-A) mortgage activity.”\footnote{John C. Dugan, “Statement Before the Financial Crisis Inquiry Commission: Appendix B,” (April 8, 2010), available at www.occ.treas.gov/news-issuances/news-releases/2010/nr-occ-2010-39d.pdf, 3.} It is significant that, prior to unveiling the data gathered by Loan Performance Corp. (LPC), then-Comptroller of the Currency, John C. Dugan, warned that the actual identities of the lenders that originated the subprime and Alt-A mortgages under examination was “captured and presented inconsistently in the database.”\footnote{Ibid.} Nearly 43% of the loans examined by LPC had “no originator information,” while others had “ambiguous names,” and still others did not “adequately distinguish among affiliated entities with similar names.”\footnote{Ibid.} Dugan even conceded that some “significant subprime originators had a large number of loans in LPC for which it was difficult to determine whether the loans were originated by [a national]
bank or by an affiliate within the larger holding company.”

Although “it was clear” to Dugan that, in each case, the subprime and Alt-A loans were originated somewhere within a given holding company, in many cases the exact originator of those loans could not be identified. The LPC was able to “reliably” identify the originator of approximately five million subprime and Alt-A loans out of an undisclosed sample size.

These troubling preliminary qualifications aside, the OCC estimates that, from 2005-2007, lenders regulated by the Fed originated 520,225 subprime and Alt-A loans (5.9% of the total), lenders regulated exclusively by state governments originated 5,241,481 subprime and Alt-A loans (60.0% of the total), lenders regulated by the FDIC (and state governments) originated 755,777 subprime and Alt-A loans (8.7% of the total), lenders regulated by the OTS originated 1,223,207 subprime and Alt-A loans (14.0% of the total), and lenders regulated by the OCC originated 999,262 subprime and Alt-A loans (11.4% of the total).

As a way of supplementing this discussion, one should consider the findings contained within a 2009 report published by The National Consumer Law Center (NCLC). The NCLC, in an effort to dispel claims that federally chartered thrifts, national banks, and their non-depository mortgage lending subsidiaries played a minimal role in the subprime and Alt-A mortgage crisis, published a report highlighting the role of these institutions in the mortgage market.

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1152 Ibid.
1153 Ibid.
1154 Ibid., 4.
1155 The LPC data does not differentiate between loans originated by affiliates of holding companies (exclusively regulated by the Fed) and those originated by state chartered national banks (regulated by the Fed and a state regulator).
role in originating subprime mortgages, focused on the number of “risky” loans that these lenders originated in 2006, the peak year for subprime lending. The NCLC limited the scope of their investigation to a single year and did not compare their results to other types of lenders, like non-depository mortgage lending affiliates. These limitations aside, the NCLC found that federally chartered thrifts, national banks, and their non-depository mortgage lending subsidiaries were responsible for originating over $700 billion worth of the riskiest mortgages in 2006. Those lenders originated 31.5% of all subprime loans, 40.1% of all Alt-A loans, and 51% of all Option ARMs that year. Having explored the extent to which each sort of lender was involved in originating risky mortgage loans, it is now necessary to examine these regulators’ relationships with one another as well as with their supervised lenders.

3.7. Securitization: Creating Conditions for the Emergence of the Subprime Mortgage Market

Over the past three decades, there has been a major structural shift within the mortgage banking industry. For most of the twentieth century, “the bulk of mortgages” in America were originated by “deposit-taking institutions, such as thrifts and commercial banks.” As recently as 1980, nearly three out of four home mortgages were funded by

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1158 Subprime loans, Alt-A loans, and Option ARMs were all considered “risky” by the NCLC in their report.
1159 National Consumer Law Center, “Preemption and Regulatory Reform: Restore the States’ Role as ‘First Responder’,” 13. An Option ARM is a type of adjustable-rate mortgage that grants borrowers some temporary loan repayment options. When the first mortgage payment is due, a borrower has the option of paying an amount equal to the monthly principle and interest, interest-only, or a minimum monthly payment. Please see: Eric M. Thorson, “Statement Before the United States Senate Permanent Subcommittee on Investigations,” (April 16, 2010), available at http://hsgac.senate.gov, 4.
1160 National Consumer Law Center, “Preemption and Regulatory Reform: Restore the States’ Role as ‘First Responder’,” 11-12.
As mortgage lenders, thrifts and national banks would “borrow” money from their depositors and then loan those funds to qualified mortgage borrowers for the sake of purchasing a home. The mortgages that these depositories originated were typically of the 30 year, fixed-rated variety and were held on their own books until the loans were repaid in full through refinance, sale of the property, or loan amortization. Depositories were able to make a profit as mortgage lenders if they could consistently pull off the difficult juggling act of lending the customer-deposited funds to mortgage borrowers at a higher rate of interest than what they agreed to pay in interest to the depositors themselves. As intermediaries between investors (the depositors) and borrowers, depositories had to offer a competitive rate of return to their investors in exchange for borrowing their money and a competitive interest rate on the mortgages that they offered to potential borrowers.

As Lewis Renieri explains, however, in the “mid to late 1970’s, people started to worry about whether… [thrifts] would be able to fund the growing demand for housing.” Housing economists “were forecasting a tremendous demand for funds for shelter” because “the baby boomers were reaching home-buying ages.” This anticipated baby-boomer demand, complemented by the serious problems that were plaguing thrifts in the 1960’s and 1970’s, raised doubts about “the ability of thrifts to

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1162 Ibid.
1164 Ibid.
1165 Ibid.
1166 Ibid.
fund housing,”1167 and paved the way for “one of the most important and abiding innovations to emerge in [the] financial markets since the 1930’s”1168: securitization.

Securitization, a term that *The Wall Street Journal* did not even consider to be a real word in 1977,1169 is “[the] process of packaging individual loans and other debt instruments, converting the package into a security or securities, and enhancing their credit status or rating to further their sale to third-party investors.”1170 It “converts illiquid individual loans or debt instruments which cannot be sold readily to third party investors into liquid, marketable securities.”1171 Another broad, potentially helpful definition of securitization is “the substitution of more efficient public capital markets for less efficient, high cost, financial intermediaries in the funding of debt instruments.”1172

Briefly, the process of securitization begins with a mortgage lender bundling its loans and selling them to “a separately incorporated affiliate or an investment bank.”1173 The buyer of this bundle, the arranger, then sells it to “second legally separate entity, which is known as a ‘special purpose vehicle’ or ‘SPV’,” which is typically a trust.1174 The two main justifications for selling pools of mortgages to a SPV are that it “shields the loans from seizure under U.S. bankruptcy laws in case the lender goes bankrupt” and it serves as a form of credit enhancement. By selling pools of mortgages to a separate legal entity, it distances the pool from the possibility of lender bankruptcy, which helps it

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1167 Ibid., 33.
1171 Ibid., 2.
1172 Ibid.
1173 Patricia A. McCoy and Elizabeth Renuart, “The Legal Infrastructure of Subprime and Nontraditional Home Mortgages,” 28.
1174 Ibid.
“qualify for a higher credit rating from the rating agencies.”\textsuperscript{1175} Once the bundles are “ensconced in a trust” or SPV, the arranger “repackages the monthly principal and interest payments from the loans into bonds, parcels out the bonds to an array of tranches with different credit risks, and sells the bonds to investors.”\textsuperscript{1176} These bonds are known as mortgage-backed securities “because they are backed by collateral in the form of the mortgages on the borrowers’ homes.”\textsuperscript{1177}

It is far beyond the scope of this work to provide a thorough exploration of the history of securitization and the important changes in the mortgage banking industry that it helped eventuate.\textsuperscript{1178} For the purposes of the present study though, one should note that the advent of securitization in the late 1970’s increasingly reduced “the need to hold deposits (or other sources of cash) to fund mortgage loans because investors… replace[d] deposits as the source of funds” for mortgages.\textsuperscript{1179} In essence, securitization created new “channels” of funding, linking a previously untapped national and, eventually, global pool of investors to borrowers who were interested in attaining a home mortgage loan.

The primary reason that securitization did a superior job “connecting” lenders to investors was that it helped ameliorate the problem of adverse selection. Prior to the advent of securitization, investors “were afraid that banks, who knew their mortgages better, would sell only the bad mortgages and keep the better mortgages on their own

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\textsuperscript{1175} Ibid.
\textsuperscript{1176} Ibid.
\textsuperscript{1177} Ibid.
\textsuperscript{1178} For an excellent treatment of these subjects, please see the previously cited: \textit{A Primer on Securitization}. Ed. Leon T. Kendall and Michael J. Fishman. (Cambridge: MIT Press, 1996).
balance sheets.” The suboptimal result due to this information asymmetry was that there was a latent pool of investor funds that was not flowing towards the financing of home mortgages. By securitizing mortgages, bundling them together into securities, and then having the riskiness of those securities evaluated by a third party (the credit rating agencies), lenders and investment banks were able to make mortgage loans a more attractive investment opportunity.

In addition to benefitting the good of homeownership in this way, securitization also addressed two severe disadvantages that accompanied the way in which depositories served as mortgage lenders. When depositories were the predominant mortgage lenders up until the 1980’s, their depositors were the “investors” whose capital was used to fund their mortgage loans. One of the main drawbacks of this method of financing mortgages was that the investor pool was overwhelmingly local. A thrift or commercial bank’s standard customer was primarily an individual who lived near one of their branch locations. From the perspective of mortgage lenders, securitization refreshed their supply of lending capital in previously unavailable ways because investments banks now had access to a much larger set of investors, each with their own tastes for risk, desires for short or long term debt, and appetites for fixed or adjustable interest rate payments. With a wider and more varied source of investor funds, investment banks could purchase a more diverse array of loans from mortgage lenders. These lenders could now, in turn, offer a more variegated set of mortgage products to better meet the needs of


1181 This instance of information asymmetry is that mortgage lenders, compared to potential investors, would likely have better knowledge of their borrowers’ ability to repay the amount that they borrowed plus interest. Thus, in the absence of credit ratings, lenders would be in a better position than investors in terms of assessing the amount of risk a given mortgage loan contained.
Subsequently, securitization buffeted investors with an unprecedented set of mortgage investment opportunities, while increasing the probability that a borrower in America could attain a home mortgage loan.

A second disadvantage to depositories funding mortgages through the deposits of their customers centers on the issue of risk. As former Freddie Mac CEO Leland Brendsel observed in 1996, “The history of housing finance in the United States has been punctuated with a series of cataclysmic failures brought by excessive exposure to interest-rate and credit risks.” Interest rate risk is the “exposure to possible losses and changes in value” brought about by changes in market interest rates, while credit risk is “the risk of loss that arises when borrowers fail to repay their loans, other parties fail to meet their obligations to administer or guarantee loans, or both.”

Prior to the advent and growth of securitization, depositories that were funding mortgage loans had to assume both of those forms of risk themselves. With respect to interest rate risk, depositories were vulnerable to hikes in market interest rates, which could potentially cause them to be funding long-term, fixed-rate mortgages with an interest rate that was suddenly lower than the one that they were impelled to offer on customer deposits. An example may be helpful here. If the market interest rate at a given time is 4%, a depository would want to offer its customers an interest rate on their deposits circulating around 4% in order to attract their business. Then, the depository could aspire to lend money to prospective home buyers at, say, 5%. Obviously, the

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depository’s goal is to lend money to home buyers at a higher rate of interest than the one at which they are paying out to their depositors.

The two principle dangers inherent in this lending and borrowing strategy were that depositories were not able to predict or control the market interest rates and, furthermore, they were “lending long” and “borrowing short.” The latter danger is a form of “duration mismatch,” which is a situation that occurs when one has asset durations that are greater than one’s liability durations. As Catherine England makes clear, the success of depositories acting as mortgage lenders in this way depends upon stable market interest rates over a long period of time. The undesirable effects of this form of duration mismatch, namely that one is paying customers more money in interest on their deposits than one is receiving from borrowers on their mortgage payments, can be somewhat minimized if market interest rates are unstable, for borrowers may potentially sell or refinance their homes before the thirty years have elapsed. Nevertheless, interest-rate risk persists even if it can be camouflaged by stable interest rates for a particular period of time.

One of the most important common assumptions about mortgage securitization, prior to the outbreak of the subprime mortgage crisis, was that it was a superior allocator of the burdens of credit and interest rate risk. For instance, mortgage securitization enabled the “interest-rate risk of mortgages [to be] borne by thousands of investors,”

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1187 Ibid.
lenders before the creation of securitization, interest rate risk was “concentrated in a few institutions or one industry, as it was for decades in the thrift industry.”\textsuperscript{1189} As for credit risk, securitization permitted mortgage lenders to diversify it “across the nation” and eventually internationally, rather than confine it “in local markets” like regions and cities, which depositories were prone to do.\textsuperscript{1190} Not only did mortgage securitization diversify the credit and interest rate risks posed by lending funds for mortgages, it also diffused those risks among individuals who were supposedly better equipped to manage them.

In more general terms, securitization “unbundled” the mortgage loan process, enabling different types of companies to specialize in separate functions.\textsuperscript{1191} Traditionally, depositories would manage the financing, originating, servicing, and risk-taking functions that were part of providing mortgage loans to borrowers. Securitization, conversely, allowed: investors to specialize in mortgage-related investments; investment banks and the government-sponsored enterprises to specialize in bundling and securitizing disparate mortgages, thereby creating investment opportunities and replenishing capital for mortgage loans; credit rating agencies to specialize in assessing the credit risks of the securitized mortgage products; lenders to specialize in originating mortgages; brokers to specialize in assisting borrowers with the loan application and loan approval processes; and servicers to specialize in managing and collecting mortgage payments from borrowers.\textsuperscript{1192}

The purpose of this small section was not to illustrate how securitization converts illiquid mortgage loans into liquid securities. Instead, the objective was to provide a brief

\textsuperscript{1189} Ibid.
\textsuperscript{1190} Ibid.
\textsuperscript{1192} Ibid.
explanation of why mortgage securitization supplanted deposit-taking/deposit-loaning as the primary method of financing home mortgages. Mortgage securitization diluted interest rate and credit risk, the key risks accompanying mortgage lending, while opening up new avenues for mortgage investing and borrowing. Additionally, securitization created conditions for the division of the mortgage loan process into separate functional areas that afforded opportunities for each participant in the process to specialize in a particular segment of it. Much of the core argument of this section can summarized this way:

The securitization process has allowed Wall Street to more efficiently finance Main Street, bringing capital from securities markets to loan originators, relieving them of the need to finance and maintain loans on their balance sheets. Further, by effectively splitting the ownership of loans into many smaller units – through the sale of securities – the [securitization] process was thought to diversify credit risk more widely across national and, indeed, global capital markets rather than concentrate that risk on the balance sheets of the institutions that originated the loans.1193

By 1994, 55.8% of all mortgages in the United States were securitized, a figure that jumped to 74.2% by 2007.1194 It is now necessary to examine other preconditions that set the stage for the subprime lending boom.

3.8. Deregulatory Preconditions for the Explosion in Subprime Lending

Since the establishment of national banks in 1864 by the National Bank Act (NBA), the existence of federally chartered and regulated depository institutions has

posed an important regulatory problem. Due to the fact that these institutions have to conduct business within state lines, what happens if their business operations conflict with a state law, but are in compliance with the requirements that are enforced by their federal regulator? In the event of a conflict, should individual state laws trump the regulations of the OCC and OTS? Or should the federal regulations preempt the laws of the states?

According to the Supremacy Clause that is found in Article VI, Section 2 of the United States Constitution, federal law is the supreme law of the land and supersedes state laws, should the two conflict with one another.1195 Somewhat surprisingly, from the time the NBA was enacted in 1864 up until 1978, “state laws governing contracts, property rights and transfers, consumer protection, and other laws” applied to the activities of depositories. During this time, federal conflict preemption was “a narrow exception to the general rule that national banks were expected to follow state laws.”1196 To substantiate this claim, consider part of an 1869 Supreme Court ruling in the case *National Bank v. Commonwealth*:

> [National banks] are subject to the laws of the State, and are governed in their daily course of business far more by the laws of the State than of the nation. All their contracts are governed and construed by State laws. Their acquisition and transfer of property, their right to collect their debts, and their liability to be sued for debts, are all based on State law. It is only when the State law incapacitates the banks from discharging their duties to the government that it becomes unconstitutional.1197

Federally chartered depositories had “rarely been permitted to ignore state law” and only then if the state laws had “prevented or significantly interfered with... [the] exercise of

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1195 Ibid., 3.
1196 Ibid., 5.
One could argue that this trend had its roots in the tenth amendment to the United States Constitution: “The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people.” Beginning in 1978, however, a landmark Supreme Court decision, followed a few years later by the passing of two congressional laws, began to chip away at the tenth amendment bulwark that had been previously protecting state laws from federal preemption, particularly those of the consumer protection variety. Coincidentally, this same series of developments paved the way for subprime mortgage lending decades later.

The first important event was the 1978 Supreme Court ruling in the case Marquette National Bank v. First of Omaha Service Corp. In their seminal ruling, the Supreme Court interpreted “the National Bank Act to hold that the applicable state interest rate cap governing lending by national banks was the interest rate law of the bank’s home state, even for loans made to consumers in other states.” The ruling focused on credit card lending, but “it was not limited to any credit product type.”

This Supreme Court decision enabled national banks to “establish their headquarters in states with high usury limits – or none at all – and charge the high interest rates permitted by the bank’s home state to borrowers located in any other state.” The ruling was dubbed “the exportation doctrine” because a national bank could “export” its

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1198 Ibid.
1199 Ibid., 4.
1200 Ibid., 6.
1201 Patricia A. McCoy and Elizabeth Renuart, “The Legal Infrastructure of Subprime and Nontraditional Home Mortgages,” 5.
1202 Ibid.
“own home state laws governing interest rates” to other states.\textsuperscript{1203} Two prominent examples of states taking advantage of this ruling were South Dakota and Delaware, both of which eliminated their state usury caps altogether. In 8 years, from 1980 to 1987, South Dakota’s revenues from its banks increased 750\%, while Delaware’s increased over 1,500\%.\textsuperscript{1204}

Far from only being a boon for national banks whose headquarters were in Delaware and South Dakota, the ruling empowered national banks across the nation, profoundly increasing their negotiating leverage with their own state legislatures. National banks began putting pressure on state governments to ease or eliminate consumer protection laws on the grounds that complying with those laws “put them at a competitive disadvantage with out-of-state banks.”\textsuperscript{1205} With the precedent being set in South Dakota and Delaware, national banks could now threaten to move their headquarters to another state, depriving their current state of taxable revenue and jobs. Ultimately, national banks with credit card operations eventually “either moved to states with no interest rate caps, or convinced their home state to deregulate.”\textsuperscript{1206}

The second important development came in 1980, when Congress passed The Depository Institution Deregulation and Monetary Control Act (DIDA) in response to the sharp increase in 30 year, fixed-rate conventional mortgage interest rates that reached as high as 13.77\% that year.\textsuperscript{1207} DIDA “completely removed state interest rate caps” for

\begin{footnotes}
\item[1203] National Consumer Law Center, “Preemption and Regulatory Reform: Restore the States’ Role as ‘First Responder’,” 6.
\item[1204] Patricia A. McCoy and Elizabeth Renuart, “The Legal Infrastructure of Subprime and Nontraditional Home Mortgages,” 6.
\item[1205] Ibid., 5.
\item[1206] National Consumer Law Center, “Preemption and Regulatory Reform: Restore the States’ Role as ‘First Responder’,” 6.
\item[1207] Patricia A. McCoy and Elizabeth Renuart, “The Legal Infrastructure of Subprime and Nontraditional Home Mortgages,” 5.
\end{footnotes}
national banks, federal credit unions, and thrifts “issuing loans secured by first mortgages on homes.”\textsuperscript{1208} The law also “preempted state limitations on a lender’s ability to assess ‘points,’ ‘finance charges,’ or ‘other charges.’”\textsuperscript{1209} Furthermore, DIDA “gave all federally chartered or federally insured depository lenders – not just national banks – the right to export their home-state interest rates when lending to consumers in other states.”\textsuperscript{1210} The third development occurred in 1982, when Congress passed The Alternative Mortgage Transactions Parity Act (AMTPA). This act primarily addressed the structure of mortgage loan products. AMPTA “removed states’ abilities to limit terms on ‘alternative’ mortgages”\textsuperscript{1211} including negative amortization loans as well as those with variable interest rates or containing balloon payments.\textsuperscript{1212}

Taken together, along with the revolutionary invention of securitization, these developments “set the legal stage for the emergence of the subprime mortgage market” in the 1990’s because they liberalized “the permissible features of loan products” and facilitated “differential pricing according to risk.”\textsuperscript{1213} Federally chartered national banks and thrifts offering loans secured by first mortgages suddenly had the freedom to offer riskier products to an expanded pool of borrowers because the features and interest rates of these products were determined by one state, their headquartered state, instead of by all of the separate states in which they conducted business. As Souphala Chomsisengphet and Anthony Pennington-Cross observe, “Many factors have contributed to the growth

\textsuperscript{1208} National Consumer Law Center, “Preemption and Regulatory Reform: Restore the States’ Role as ‘First Responder’,” 6.
\textsuperscript{1209} Ibid.
\textsuperscript{1210} Ibid.
\textsuperscript{1211} Ibid., 7.
\textsuperscript{1212} Patricia A. McCoy and Elizabeth Renuart, “The Legal Infrastructure of Subprime and Nontraditional Home Mortgages,” 6.
\textsuperscript{1213} Ibid., 7.
of subprime lending. Most fundamentally, it became legal.”¹²¹⁴ It is now necessary to
discuss perhaps the most important deregulatory precondition for the explosion of
subprime lending: widespread federal preemption of state consumer protection laws.

3.9. OTS and OCC Federal Preemption: A Boon for Subprime Lenders, A Liability
for Borrowers

Although the OTS issued its pervasive federal preemption regulations in 1996, the
agency preempted a minimal amount of state laws for seven subsequent years.¹²¹⁵ Thus,
despite being the first agency to adopt federal preemption, the latent dangers of this
power managed to remain largely undetected during the nascent stages of the subprime
boom in the early 2000’s.¹²¹⁶ One could argue that, in 2003, those dangers, along with the
others that accompanied the federal deregulation efforts over the previous two decades,
finally began to materialize.

In 2001, subprime lenders originated $180 billion worth of subprime mortgages, a
number that increased nearly 34% to $241 billion in 2002,¹²¹⁷ which was more than the
entire gross domestic product of Sweden.¹²¹⁸ As subprime loan originations increased, so
too did the number of consumer complaints about - and state responses to - predatory

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¹²¹⁴ Souphala Chomsisengphet and Anthony Pennington-Cross, “The Evolution of the Subprime Mortgage
Market,” *Federal Reserve Bank of St. Louis Review*, (January/February 2006), available at
¹²¹⁵ Colin Provost, “Another Race to the Bottom? Venue Shopping for Regulators in the American
Financial System,” *Paper Prepared for the Third Biennial Conference of the Standing Group on
Regulatory Governance, Dublin, Ireland* (June 2010), available at http://regulation.upf.edu/dublin-10-
papers/7A3.pdf, 14.
¹²¹⁶ Patricia A. McCoy, Andrey D. Pavlov, and Susan M. Wachter, “Systemic Risk Through Securitization:
The Result of Deregulation and Regulatory Failure,” *University of Connecticut Law Review*, Vol. 41, No. 4
(May 2009), 1351.
(March 3, 2003).
¹²¹⁸ Nicholas Bagley, “The Unwarranted Regulatory Preemption of Predatory Lending Laws,” *New York
lending practices. One notable state government reaction to the surge in predatory lending accusations was in the state of Georgia. In 2002, Georgia’s state government passed The Georgia Fair Lending Act (GFLA), which “imposed unlimited, unconditional assignee liability on anyone who became an assignee or a holder of a mortgage loan.” Provocatively, GFLA allowed borrowers in Georgia who believed that they had been “victims of predatory lending to sue not only the original lender but also anyone who later buys the mortgage.” This provision virtually shut down the subprime mortgage market in Georgia because the major credit rating agencies refused to rate mortgage-backed securities containing high risk loans. Without credit ratings, many investors were prohibited from investing in these mortgage-backed securities, which eliminated the securities’ liquidity. In short, investors ceased investing in subprime mortgage-backed securities that contained loans that were originated in Georgia, so lenders in the state cut back on originating them. Early the next year, the New York state government passed predatory lending laws of its own that became effective on April 1, 2003.

As Donald C. Lampe observes, these and other state anti-predatory lending laws gave rise to an important question: “Do state and local high-cost home loan or ‘predatory lending’ laws interfere with or obstruct basic banking and lending functions and/or the dominion of federal regulators, including the Office of the Comptroller of the Currency

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1222 Ibid.
Lampe’s question resists a simple answer because DIDA and AMPTA legalized many of the features of loans that are considered to be predatory. Moreover, as Diana McMonagle makes clear, in order to know whether a loan is predatory or not, one needs to grasp the lender’s *intent* behind originating the loan, a piece of information that can be difficult to attain. A predatory loan, for example, could be one in which a lender is attempting to “profit from intentionally and systematically taking advantage of unsophisticated borrowers,” and purposefully structuring loans to “cause economic harm to the borrower – at a significant profit to the lender.” Defining the term “predatory lending” or a “predatory loan” in a way that is neither over-inclusive nor under-inclusive is essential to discerning whether a state anti-predatory law or group of laws interferes with the legitimate business operations of federally chartered depositories and the activities of their regulators within state lines.

This caveat aside, the OTS announced in 2003 that they were going to preempt both Georgia’s and New York’s state predatory lending laws for federally chartered thrifts and their operating subsidiaries. A few months later, the director of the OTS at the time, James Gilleran, along with three other federal banking regulators, “posed for photographers behind a stack of papers wrapped in red tape.” While the other

1225 Ibid.
1226 Julie L. Williams and Michael S. Blysma, “The Predatory Lending Challenge.”
regulators held garden shears, Gilleran “hefted a chain saw.” The message was clear: the OTS would imminently serve as a “safe zone” for federal thrifts against the panoply of state lending laws.

To put this decision in perspective, one should note that, in 2002, the OTS was left “reeling” from the embarrassing failure of one of its chartered thrifts, Superior Bank. This failure was mostly due to the thrift’s large scale origination and securitization of subprime loans. Soon after this failure, rumors began to circulate that the OTS “might be ripe for abolition.” The OTS, therefore, had a compelling reason to issue its preemption pronouncement in 2003. By easing state regulatory restraints on its chartered thrifts and their non-depository mortgage lending subsidiaries, the OTS could entice national and state banks to switch their charter and become federally chartered thrifts. The more federally chartered thrifts that the OTS had under its watch, the more relevant and vital the agency would seem in the eyes of the federal government.

In response to the OTS preemption pronouncement, national banks and their mortgage lending subsidiaries began lobbying their federal regulator, the OCC, “to afford them the same relief as thrifts.” Burdened by “a patchwork of different and sometimes demanding states laws,” the national banks and their mortgage lending subsidiaries contended that they were now at a competitive disadvantage and the victims of uneven

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1229 Ibid.
1230 The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps, 158.
1233 Ibid.
1234 Patricia A. McCoy and Elizabeth Renuart, “The Legal Infrastructure of Subprime and Nontraditional Home Mortgages,” 12.
regulation.\textsuperscript{1235} They were subjected to onerous “compliance costs and litigation risks” from which federally chartered thrifts and their subsidiaries were exempt.\textsuperscript{1236} For instance, a California state law that mandated a minimum payment warning to borrowers imposed $44 million in start-up costs on six national banks, costs that OTS-regulated lenders could now ignore.\textsuperscript{1237} Another example can be found in 2002 when 38 states settled with the national bank, Household Finance, for $484 million over the bank’s “predatory, deceptive and fraudulent practices.”\textsuperscript{1238} As explained by Colin Provost, the director of the OCC, John D. Hawke, knew that if state consumer protection laws continued to apply to national banks and their subsidiaries, then “the OCC might lose some of its banks to the more relaxed thrift charter.”\textsuperscript{1239}

Within months of the OTS announcement, the OCC determined, in August of 2003, that the National Bank Act “preempted the GFLA as applied to national banks and their subsidiaries.”\textsuperscript{1240} At the same time, the OCC proposed another regulation that eventually went into effect on January 7, 2004. This regulation preempted “all state predatory lending laws… as applied to national banks” and their operating subsidiaries.\textsuperscript{1241} Although the OCC adopted a rule later in 2004 that banned “unfair and deceptive acts and practices and mortgages made without regard to borrower’s ability to repay,” perhaps in an effort to fill the consumer protection void created by its widespread federal preemption, the rule nevertheless did not “explicate what constituted an unfair or

\begin{itemize}
\item \textsuperscript{1235} Ibid., 16.
\item \textsuperscript{1236} Wookbai Kim, “A Study on How Regulatory Capture Caused the Subprime Mortgage Crisis and What to Do for Robust Consumer Protection,” 134.
\item \textsuperscript{1237} Ibid., 135.
\item \textsuperscript{1238} Colin Provost, “Another Race to the Bottom? Venue Shopping for Regulators in the American Financial System,” 15.
\item \textsuperscript{1239} Ibid.
\item \textsuperscript{1240} Nicholas Bagley, “The Unwarranted Regulatory Preemption of Predatory Lending Laws,” 2284. 12 C.F.R. § 7.4007-7.4009.
\item \textsuperscript{1241} Ibid., italics his. 12 C.F.R. § 7.4000.
\end{itemize}
deceptive lending act or practice.” Furthermore, the rule “allowed national banks to ‘use any reasonable method to determine a borrower’s ability to repay, including, for example… credit history, or other relevant factors.’” As Patricia McCoy and Kathleen Engel argue, this provision created a space for OCC-regulated lenders to construe “qualifying borrowers solely based on their credit scores for low-doc and no-doc loans” as a “reasonable” practice. As for the OTS, they never adopted any “binding rules on sound loan underwriting” for their regulated thrifts and mortgage lending subsidiaries to replace those state lending laws that they preempted.

Collectively, the OTS and OCC regulations permitted federally chartered thrifts, national banks, and their respective mortgage lending subsidiaries to originate mortgage loans without regard to a host of state laws including:

- Licensing, registration, or reporting by creditors; the ability of a creditor to require or obtain insurance for collateral or other credit enhancement or risk mitigant; loan-to-value ratios; the terms of credit, including the schedule for repayment of principal and interest, amortization of loans, balance, payments due, minimum payments, term to maturity of the loan, or the ability to call the loan due and payable upon the passage of time or a specified event external to the loan; escrow or similar accounts; security property; access to and use of credit reports; disclosure and advertising requirements in credit application forms, credit solicitations, billing statement, credit contracts, or other related documents; disbursements and repayments; rates of interest; the aggregate amount of funds that can be loaned upon the security of real estate; processing, origination, servicing, sale, or purchase of, investment in, or participation in mortgages… and covenants and restrictions that must be contained in a lease to make it qualify as acceptable security for a real estate loan.

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1242 The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps, 168.
1243 Ibid.
1244 Ibid.
1245 Ibid., 184.
This newly established reach of OCC preemption elicited “pronounced public outcry,” especially among state enforcement authorities and consumer advocates, because for over a century individual states had jurisdiction over consumer protection issues.\(^{1247}\) A statement published by the NCLC in October of 2003 pointed out that Congress expressly “delegated to the OCC the task of supervising national banks and protecting their viability by making sure that they do not engage in unsafe and unsound practices.”\(^{1248}\) Similarly, Congress “created the OTS exclusively for the purpose of regulating the thrift industry, and expected the strong hand of the OTS to provide stability for the thrifts.”\(^{1249}\)

Ensuring the safety and soundness of national banks and thrifts, protecting them from failure, was the original, congressionally-granted responsibility assigned, respectively, to the OCC and the OTS. Congress never authorized either of the federal regulators to serve as consumer protection agencies.\(^{1250}\) Even if the OCC and OTS happened to be better suited for protecting consumers from predatory lending practices than individual state governments,\(^{1251}\) protecting consumers can be costly to national banks, thrifts, and their mortgage lending subsidiaries.\(^{1252}\) As a result, if the OCC or OTS “took actions simply for the protection of the customers,” and those actions had a negative impact on the profitability of their national banks or thrifts, the two federal regulators could potentially violate their statutory authority to the ensure safety and


\(^{1249}\) Robert Cooper, “Note: Office of Thrift Supervision,” S363.


\(^{1251}\) This is a generous assumption. As Diana Taylor, the superintendent of banks in New York, stated, “The state legislature has a better idea of the consumer situation in the state than an unelected official in Washington.” Please see: Jonathan Fuerbringer, “Some Exemptions Are Proposed on Predatory Lending Laws,” The New York Times (August 1, 2003).

soundness of their national banks and thrifts.\textsuperscript{1253} Paradoxically, while fostering the profitability of national banks and thrifts is an integral part of ensuring their safety and soundness, safeguarding sufficient consumer protections can be costly to those same lenders, thus impinging upon their profitability and, potentially, increasing the likelihood of their failure. If the OCC and OTS’ primary regulatory objective is to ensure the safety and soundness of their national banks and thrifts, then, first and foremost, this entails protecting their profitability.\textsuperscript{1254}

This tension between two conceivably conflicting objectives, ensuring the safety and soundness of their chartered institutions and protecting consumers, was heightened by an additional factor: the “customers” of the OCC and OTS are their chartered institutions. The OCC and OTS “pay for their operations from the chartering, annual, and examination fees” that they collect from their chartered national banks and thrifts.\textsuperscript{1255} The larger and more numerous their chartered institutions are, the more revenue the OTS and OCC receive. One result of this arrangement was that the two federal regulators had to compete against one another – and the individual state regulators – for their charters.\textsuperscript{1256}

In general, depositories face relatively low charter-switching costs. This put them in a position to “exploit differences in [federal] agency policy by seeking to be chartered by the agency with the most relaxed regulations,”\textsuperscript{1257} a technique that Sheila Bair,\textsuperscript{1258} Oren Bar-Gill and Elizabeth Warren, “Making Credit Safer,” \textit{University of Pennsylvania Law Review}, Vol. 157, No. 1 (2008-2009), 190.
\textsuperscript{1255} Patricia A. McCoy and Elizabeth Renuart, “The Legal Infrastructure of Subprime and Nontraditional Home Mortgages,” 24.
\textsuperscript{1256} Ibid.
Chairman of the FDIC, called “regulatory arbitrage.”\textsuperscript{1258} On average, both the OTS and OCC charge their chartered institutions higher fees than individual state regulators\textsuperscript{1259} because the latter are subsidized by the FDIC and the Fed.\textsuperscript{1260} Unable to compete with state governments on the amount that they charged their “customers” in fees, the OTS and OCC established their competitive advantage by making their regulations uniform (applicable in all states) and expanding the scope of their chartered institutions’ permitted activities.\textsuperscript{1261} Federal preemption engendered both of those advantages, which appealed to large depositories with “coast-to-coast operations that found it inconvenient to comply with fifty state laws.”\textsuperscript{1262}

Competition between the OTS and OCC was exacerbated by the way in which the banking industry in general, and the subprime lending industry in particular, became progressively concentrated in the 1990’s and early 2000’s. From 1993 to 1997, 21% of depositories were acquired in a merger or acquisition.\textsuperscript{1263} Between 1990 and 2005, “74 ‘megamergers’ occurred involving banks with assets of more than $10 billion each… [and] the largest [depositories] jumped from owning 25% of the industry’s assets to 55%.”\textsuperscript{1264} In terms of the subprime lending industry, “the market share of the top 25 firms

\textsuperscript{1258} National Consumer Law Center, “Preemption and Regulatory Reform: Restore the States’ Role as ‘First Responder’,” 21.
\textsuperscript{1259} The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps, 158.
\textsuperscript{1261} Ibid., 33.
\textsuperscript{1262} The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps, 159.
making subprime loans grew from 39.3 percent in 1995 to over 90 percent in 2003.”

With increasingly less depositories to charter, and many depositories growing in size, acute pressure was placed on the OCC and OTS to win over as many depositories to their respective charters as they could manage. The best way to accomplish this goal was to offer depositories “a bigger menu of legally permissible banking activities and gentler regulation and laws.”

The effects of the OCC preemption regulations were immediate. As a Government Accountability Office (GAO) report states, “the share of assets divided among federally chartered and state-chartered banks remained relatively steady for [the] decade” preceding the OCC preemption regulations. National banks during this time held an average of 56% of all bank assets, while state banks held an average of 44%. Beginning in 2004, however, “the share of assets of banks with a federal charter increased to 67 percent, and the share of bank assets of banks with state charters decreased to 33 percent.” Two of the largest depositories to switch from a state to federal charter soon after the OCC preemption regulations took effect were JPMorgan Chase and HSBC. After those two depositories changed their charters, one state regulator instantaneously lost approximately 30% of its revenue.

1266 The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps, 158.
1268 Ibid.
1269 Ibid.
1270 Ibid., 30.
This loss prompted the GAO to analyze the funding information of two other states to “estimate how a change to the federal charter by the largest state bank in each state” would affect those state regulators’ budgets.\textsuperscript{1271} The results of their investigation were unsettling: the first state’s revenue would decrease by 43 percent if its largest chartered bank switched to a federal charter, while the second state’s revenue would decrease by 39 percent.\textsuperscript{1272} As the majority of the largest state-chartered depositories operated in multiple states, many state officials feared that those institutions would be tempted to switch to a federal charter, for it would make it easier and less costly for them to conduct business.\textsuperscript{1273} Even if state regulators maintained their “predatory lending laws in the face of preemption,” only state-chartered institutions would bear the costs, creating a powerful incentive for those institutions to change to an OCC or OTS federal charter.\textsuperscript{1274}

Accordingly, in order to remain competitive with the OCC and OTS, 46 states adopted parity laws that granted “state-chartered banks the same powers given to national banks.”\textsuperscript{1275} This surprising decision resulted in those states repealing their “own stringent consumer protection laws against state-based subprime mortgage lenders.”\textsuperscript{1276} As odd as it might seem, since national banks were permitted to ignore state consumer protection laws, and 46 states chose to recognize their chartered banks as legally equivalent to national banks, those state-chartered banks could now disregard their own state’s consumer protection laws. As Kevin Stein, the associate director of the California

\textsuperscript{1271} Ibid.
\textsuperscript{1272} Ibid.
\textsuperscript{1273} Ibid., 33-34.
\textsuperscript{1274} Nicholas Bagley, “The Unwarranted Regulatory Preemption of Predatory Lending Laws,” 2284.
Reinvestment Coalition observed, “It was a legislative and regulatory race to the bottom.”\(^\text{1277}\)

As one could easily predict, this deregulatory chain-reaction had a devastating impact on subprime borrowers that had been the victims of predatory lending abuses. As Patricia McCoy and Kathleen Engel explain, federal preemption “prevented borrowers who received loans from national banks, federal savings associations, or their subsidiaries from suing their lenders for lending abuses under state laws.”\(^\text{1278}\) Numerous borrowers who contacted federal call centers to voice their complaints about the lending activities of a national bank, thrift, or mortgage lending subsidiary were frequently met with indifference. The OCC handled “all consumer complaints filed against national banks through a single call center,” one whose staff represented “less than two percent of the OCC’s total workforce.”\(^\text{1279}\) The federal regulator set aside a little over one percent of its operating budget in 2005 to fund all of the call center’s operations.\(^\text{1280}\) Aggrieved borrowers who called the center were told that “only a court of law can resolve ‘factual or contractual disputes between the bank and the customer.’”\(^\text{1281}\) As a result, the call center advised consumers that if “your case involves such a dispute… you [should] consult an attorney for assistance.”\(^\text{1282}\) That same year, in 2005, the OCC reported that its “customer assistance group” employed a grand total of three people whose job primarily

\(^\text{1277}\) Bethany McLean and Joe Nocera, *All the Devils are Here: The Hidden History of the Financial Crisis* (New York: Penguin, 2010), 148.

\(^\text{1278}\) The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps, 162.


\(^\text{1280}\) Ibid.

\(^\text{1281}\) Ibid.

\(^\text{1282}\) Ibid.
involved investigating and resolving consumer complaints."\textsuperscript{1283} As Arthur Wilmarth, Jr. concludes, the OCC did not view itself as “a vigorous defender of consumer rights” and had a supervisory and examination process that did not “establish any formal procedures for granting relief to injured borrowers.”\textsuperscript{1284} As for the OTS, it did not have a centralized consumer protection branch as late as 2005 and perhaps even later than that.\textsuperscript{1285}

In the absence of robust consumer protection laws, by default “the law” became the terms and conditions that were contained in the mortgage loan contracts between lenders and borrowers.\textsuperscript{1286} These contracts were “contracts of adhesion, meaning the consumer cannot negotiate the printed terms.”\textsuperscript{1287} They were crafted exclusively by the lenders, with no borrower input. The lone borrower “protection” in this case was the borrowers’ diligence in scrutinizing their loan contracts. The unspoken notion of “caveat emptor,” then, was essentially the last remaining subprime borrower protection in place by 2004.\textsuperscript{1288} The National Consumer Law Center argued that even if this form of protection happened to be adequate, it was still “inappropriate” because its core message to borrowers is “assume that all business people are out to cheat you until proven otherwise.”\textsuperscript{1289}

One of the other main weaknesses of relying too heavily upon the “buyer beware” form of subprime borrower protection is that it tends to discount the fact that the

\textsuperscript{1284} Ibid., 18.
\textsuperscript{1286} Patricia A. McCoy and Elizabeth Renuart, “The Legal Infrastructure of Subprime and Nontraditional Home Mortgages,” 26.
\textsuperscript{1287} Ibid. 26-27.
\textsuperscript{1288} Ibid., 27.
subprime mortgage market is mostly a “push market,” one in which “armies of telemarketers, brokers, and loan officers target borrowers and solicit business.”1290 In 2006, the GAO gathered information from a variety of sources, including “federal and state banking regulators, consumer groups, and the mortgage industry,” in order to conduct an examination on alternative mortgage product (AMP) trends and their risks to lenders and borrowers.1291 The GAO reviewed a pool of marketing materials issued by subprime lenders and asserted that “they may not clearly provide information to inform consumers about the potential risks” of the mortgage products.1292 The GAO offered a few examples to support their claim:

For example, one advertisement we reviewed promoted a low initial interest rate and low monthly mortgage payments without clarifying that the low interest rate would not last the full term of the loan. In other cases, promotional materials emphasized the benefits of AMPS without effectively explaining the associated risks. Some advertising, for example, emphasized loans with low monthly payment options without effectively disclosing the possibility of interest rate changes or mortgage payment increases. One print advertisement we reviewed for a payment-option ARM emphasized the benefit of a low initial interest rate but noted in small print on its second page that the low initial rate applied only to the first month of the loan and could increase or decrease thereafter.1293

The GAO further discovered that, in general, the mortgage disclosures that they reviewed “did not conform to leading practices in the federal government, such as key ‘plain English’ principles for readability or design.”1294 In fact, the GAO found that the disclosures were primarily “written with language too complex for many adults to fully

1292 Ibid., 7.
1293 Ibid.
1294 Ibid., 8.
understand.”\textsuperscript{1295} Finally, the GAO argued that the majority of the disclosures “used small, hard-to-read typeface, which when combined with an ineffective use of white space and headings, made them even more difficult to read and buried key information.”\textsuperscript{1296}

The “caveat emptor” form of borrower protection also discounts the fact that subprime lenders could falsify the borrower’s loan applications by forging signatures, backdating documents, misstating the borrower’s income level, and implementing a variety of other techniques.\textsuperscript{1297} Lenders servicing their mortgages after closing could also prey upon borrowers by soliciting multiple and detrimental refinancings, charging excessive late fees, and subjecting them to abusive collection practices.\textsuperscript{1298}

Overall, the deterioration of consumer protection laws for borrowers obtaining subprime mortgages came at the most inopportune time. Angelo Mozilo, former CEO of what ended up being the largest subprime lender,\textsuperscript{1299} Countrywide Financial, looked back on the climate of the mortgage lending market in the early 2000’s and characterized it as being dominated by a “gold rush mentality.”\textsuperscript{1300} In a moment of profound clarity, Mozilo stated, “Housing suddenly went from being part of the American dream to house my family… [and then] it became a commodity. That was a change in the culture… It was sudden, unexpected.”\textsuperscript{1301} This commoditizing of housing was present, for example, in Countrywide’s decision to partner with other firms, like American Airlines and Hilton Hotels, to offer borrowers reward points or airline miles that could be redeemed for free

\textsuperscript{1295} Ibid., 9.
\textsuperscript{1296} Ibid.
\textsuperscript{1297} National Consumer Law Center, “Comments on Behalf of Low Income Clients Regarding Petition for Rulemaking to Preempt Certain State Laws.”
\textsuperscript{1298} Ibid.
\textsuperscript{1299} The Center for Public Integrity, \textit{Who’s Behind the Financial Meltdown: The Top 25 Subprime Lenders and Their Wall Street Backers}, 51.
\textsuperscript{1301} Ibid., 6. Italics mine.
hotel stays or flights, in exchange for taking out a home equity line of credit loan.\textsuperscript{1302} Countrywide even had a promotion in which they offered “double rewards” for a limited time.\textsuperscript{1303} Another example can be found in Countrywide’s decision to offer borrowers home equity lines of credit worth up to 100 percent of the value of their home, a product “with the same conveniences of a credit card, but with a much lower interest rate.”\textsuperscript{1304} In a later section, Countrywide’s lending practices will be examined in greater detail.

To summarize, when state consumer protection laws were displaced by federal preemption, the subprime lending market became a financial minefield for many borrowers. This sentiment was stated succinctly by attorney Irv Ackelsberg in 2007:

The subprime mortgage market has, for the last decade, grown at an astronomical rate. This growth has been fueled in large part by a collapse in underwriting practices and responsible lending principles; by a sales-pressured, get-rich-quick environment that has infected the market with blatant fraud and abuse, and a regulatory apparatus that has abdicated its traditional role to protect the American consumer from exploitative lending practices… To put it bluntly, mortgage origination practices have been run over by the pursuit of profits at any cost.\textsuperscript{1305}

The rampant federal preemption measures that the OCC and OTS initiated were never supplemented by rigorous consumer protection regulations,\textsuperscript{1306} a turn of events that left borrowers particularly susceptible to deceptive and pernicious lending practices employed by thrifts, national banks, and their operating subsidiaries.

\textsuperscript{1302} “Countrywide Offers Double Rewards for Home Equity Lines of Credit; Consumers Earn Rewards Toward Free Travel And Lodging with Special Limited Time Offer,” \textit{PR Newswire} (December 22, 1999).
\textsuperscript{1303} Ibid.
\textsuperscript{1304} “Countrywide Offers Affordable 100% Home Equity Financing; Consumers Can Cut the Costly Credit Cards and Turn to HELOCs,” \textit{PR Newswire} (November 18, 1999).
3.10. The OCC and OTS: The Question of Safety and Soundness

Turning away from the question of how well the OCC and OTS were able to serve as consumer protection agencies during the early 2000’s, one may be curious about the extent to which the two regulators were able to ensure the safety and soundness of the lenders under their supervision that were originating subprime mortgages. With a plethora of depositories and mortgage lending subsidiaries under their regulatory oversight, some of which switched charters during this time, the scope of this question is unmanageably vast. Still, one can acquire at least a sense of the quality of the two regulators’ safety and soundness regulation by briefly looking at the deregulatory environment that they created and a few of the decisions that were made by some of their largest subprime lenders right before the crisis began to unfold in 2007.

As federally chartered depositories and their operating subsidiaries began originating more and more risky subprime mortgage loans in the early 2000’s, both the OCC and OTS made the curious decision to address this risk by issuing “advisory guidances… [instead of] binding regulations.”\(^\text{1307}\) It is a puzzling fact that both federal regulators had an aversion to “dictating underwriting standards to lenders,” despite the fact that those standards were clearly slipping.\(^\text{1308}\) Interagency guidance on nontraditional mortgage loans, which was created by the OCC, OTS, and three other federal regulators, did not appear until September 2006, well after the housing bubble had become over-inflated. Moreover, the guidance itself “did not cover subprime loans generally,” only Option ARMs.\(^\text{1309}\) With respect to Option ARMS, the guidance failed to place “firm

\(^\text{1307}\) The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps, 165.
\(^\text{1308}\) Ibid.
\(^\text{1309}\) Ibid., 168.
limits on low-doc and no-doc underwriting.” As for the OCC, the Comptroller of the Currency at the time, John Dugan emphasized “the need for careful underwriting” to its regulated national banks, but simultaneously reassured them that the regulator would only use enforcement “as a last resort.”

The OCC, OTS, and the three other federal banking regulators did not actually issue the subprime guidance until early 2007, which was approximately at the same time that the mortgage market began to fall apart. The federal agencies maintained that they issued the guidance because they were “concerned that subprime borrowers may not fully understand the risks and consequences of obtaining certain adjustable-rate mortgage (ARM) products.” In particular, the agencies expressed concern over subprime Option ARMs and NINA (No Income No Asset documentation) loans.

The tardiness of the guidance was not overlooked by Congressman Brad Sherman during a September 2007 hearing conducted by the United States House of Representatives Committee on Financial Services. Congressman Sherman highlighted the fact that the OCC could have banned its national banks and their operating subsidiaries from originating NINA loans ten years earlier, well-before the financial “hurricane”

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1310 Ibid.
1311 Ibid., 176.
1312 Ibid., 168.
1313 Ibid., 174.
1315 Ibid.
struck, and then he asked then-Comptroller of the Currency John Dugan, why the OCC had not done so. Dugan’s rather bizarre answer was that the OCC believed that NINA loans somehow reduced the risk of borrowers pretending “they made more income than they actually made in order to get a loan that they could not repay.” Congressman Sherman rebutted that NINA loans actually facilitated borrower-related fraud and asked Dugan whether the OCC ever attempted to prohibit NINA loans. Dugan’s response was that the OCC had not done so because the growth of those loans “developed over a period of time” and they “began to creep into the mortgage underwriting practice as a more and more standard practice.” In light of this gradual growth, Dugan affirmed that the OCC began “issuing stronger and stronger directives” against originating NINA loans.

Aside from the late emergence of the subprime guidance, the federal agencies did not even require their lenders to conform to their recommendations. In fact, their form of guidance was non-binding, which created space for lenders to interpret the agencies’ remarks as mere recommendations. For example, after the OTS met with Washington Mutual, one of its chartered thrifts, to discuss the subprime guidance, one Washington Mutual official wrote an internal memo that stated, “They specifically pointed out that the language in the guidance says ‘should,’ vs. ‘must’ in most cases and they are looking to WaMu to establish our own position of how the guidance impacts our business processes.” Another response to the guidance came from a Senior Vice President of

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1317 Ibid., 46-47.
1318 Ibid., 47.
the Mortgage Bankers Association, who claimed that the regulators made a “key error” by asking “lenders to make sure they qualify borrowers at higher rates that kick in when the loans reset” because such an approach to lending would “limit the ability of some borrowers to obtain credit.”\textsuperscript{1321} Suggesting that lenders qualify borrowers at the fully indexed rate would also eat into those lenders’ profits, for they would be forced to approve fewer loan applications.

One has to wonder how much compliance a federal regulator is going to receive from its regulated lenders when it is merely suggesting that those lenders act in immediately less profitable ways. This consideration, in turn, prompts one to reflect upon whether the OCC and OTS could have ever ensured the safety and soundness of their regulated lenders without imposing binding regulations on them. The evidence suggests that they severely struggled with this task and I will briefly examine two OCC-regulated lenders (Wells Fargo Home Mortgage and Chase Home Finance) and one OTS-regulated lender (Washington Mutual) to support this claim.

3.11. A Snapshot of the OCC’s Safety and Soundness Regulation: Wells Fargo Home Mortgage and Chase Home Finance

At the end of 2006, the peak year for subprime lending, two of the OCC’s largest subprime lenders under its watch were Wells Fargo Home Mortgage (a subsidiary of Wells Fargo Bank, N.A.) and Chase Home Finance (a subsidiary of JPMorgan Chase Bank, N.A.).\textsuperscript{1322} Beginning with Wells Fargo Home Mortgage, a revealing 2007 prospectus of one of their Alt-A securitizations provides a unique window into the firm’s regulatory relationship with the OCC. In this prospectus, which is a public document,

\textsuperscript{1321} Ibid.
\textsuperscript{1322} The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps, 205.
Wells Fargo admitted that it had “loosened its underwriting standards… with knowledge that delinquencies and foreclosures could increase.” Also contained in the prospectus is the disclosure that “over 75 percent of the loans in the loan pool” were either “low-doc or no-doc loans.” Incredibly, Wells Fargo proceeded to state that it had financed loans in the pool through third parties, even though those parties had not complied with their own underwriting standards. This last admission was a “blatant violation of an OCC bulletin that required Wells Fargo to ‘implement an ongoing oversight program over’ mortgage brokers’ activities.” Ultimately, Wells Fargo financed nearly $52 billion worth of subprime and Alt-A mortgages. In October of 2008, they received a $25 billion Troubled Asset Relief Program injection.

Approximately four years later, on October 9, 2012, the United States filed a civil mortgage fraud lawsuit against Wells Fargo. As the lawsuit notes, Wells Fargo had been a participant in the Direct Endorsement Lender (DSL) program since 1986. As an authorized DSL, Wells Fargo had “the authority to originate, underwrite, and certify mortgages for FHA insurance.” The lawsuit alleges that between May 2001 and October 2005, Wells Fargo “certified that over 100,000 retail FHA loans met HUD’s requirements and therefore were eligible for FHA insurance,” while knowing that “a very substantial percentage of those loans – nearly half in certain months – had not been

1324 Ibid.
1325 Ibid.
1326 Ibid.
properly underwritten, contained unacceptable risk, did not meet HUD’s requirements, and were ineligible for FHA insurance.”

The lawsuit claims that “the extremely poor quality” of Wells Fargo’s loans “was a function of [its] management’s nearly singular focus on increasing the volume of FHA originations – and the bank’s profits – rather than on the quality of the loans being originated.” The United States Attorney for the Southern District of New York declared, “As the complaint alleges, yet another major bank has engaged in a longstanding and reckless trifecta of deficient training, deficient underwriting and deficient disclosure, all while relying on the convenient backstop of government insurance. As also alleged, Wells Fargo’s bonus incentive plan – rewarding employees based on the sheer number of loans approved – was an accelerant to a fire already burning, as quality repeatedly took a back seat to quantity.” The United States is seeking hundreds of millions of dollars in damages as of October of 2012.

A second large subprime lender that the OCC oversaw was Chase Home Finance, a lender that eventually financed over $30 billion worth of subprime and Alt-A loans. A sense of JPMorgan Chase Bank’s relationship with the OCC can be gleaned from two instructive examples. First, on September 15, 2006, the OCC approved an application by Chase to “acquire certain assets and assume certain deposits from The Bank of New York.” Eleven different community organizations objected to Chase’s acquisition of

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1330 Ibid.
1331 Ibid.
1332 Ibid.
1333 The Center for Public Integrity, Who’s Behind the Financial Meltdown: The Top 25 Subprime Lenders and Their Wall Street Backers, 14.
these assets and deposits, most notably because of “certain products” that Chase was offering at the time.1335 Two of these products are worth mentioning.

The first of these objectionable Chase products was the piggyback mortgage, which is a simultaneous second mortgage with a high interest rate that is designed for borrowers whose first mortgage cannot cover all their initial home buying costs.1336 The community organizations voiced concern that Chase was using piggyback mortgages to leverage low- and middle-income, first-time homebuyers “into financing that is unaffordable” and to “sell properties that are intentionally over-appraised.”1337 The OCC responded to this concern by noting that Chase “does not view [piggyback mortgages] as presenting increased risk to the bank or to borrowers” because the firm uses “a variety of screens” and applies “appraisal methods and standards [that] are the same” as the ones that they apply to “traditional products.”1338

The second product was Chase’s NINA loans.1339 A former regional vice president at Chase Home Finance confessed, “If you had some old bag lady walking down the street and she had a decent credit score, she got a loan” at Chase.1340 With respect to this second product, the community organizations argued that NINA loans can be “easily used to put lower income borrowers into unaffordable loans, which place them at high risk of default and foreclosure.”1341 The same former regional vice president at Chase Home Finance conceded that certain account executives received commissions that were up to seven times higher from subprime mortgages, when compared to prime

1336 Ibid.
1337 Ibid.
1338 Ibid., 6-7.
1339 Ibid., 7.
mortgages. As a result, an incentive structure was in place at Chase Home Finance for executives to look for “less savvy borrowers - those with less education, without previous mortgage experience, or without fluent English” and nudge them toward subprime loans. This orientation towards lending resulted in these vulnerable borrowers, who were “disproportionately blacks and Latinos,” being stuck with more expensive mortgages, increasing the probability that they would eventually lose their homes.

The community organizations expressed a similar concern. They argued that many of Chase Home Finance’s NINA loans were “arranged by mortgage brokers whose only incentive is to close the loan,” as opposed to ensuring that the borrowers could actually repay the loan in full. In response to these concerns, the OCC affirmed that it had “previously determined that the system of checks and balances, fraud detection, and audit procedures” in place at Chase were “satisfactory and provide an adequate level of protection to the bank with regard to this product.” By the end of 2007, Chase announced that they would no longer finance any NINA loans as part of their effort to tighten their underwriting standards, having suffered losses totaling $1.2 billion from non-performing mortgages that year.

To get an even better feel for the regulatory relationship between Chase and the OCC, one can examine a March 2008 article written in The Oregonian, which exposed a leaked memo that was in circulation for an unknown period of time. The memo was titled “Zippy Cheats & Tricks” and was “a primer on how to get [NINA] loans approved

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1342 Nicholas D. Kristof, “A Banker Speaks, With Regret.”
1343 Ibid.
1344 Ibid.
1346 Ibid., 8.
1347 Jeff Manning, “Chase Mortgage Memo Pushes ‘Cheats & Tricks’,” The Oregonian (March 27, 2008).
1348 Ibid. I also discovered this example from: The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps, 170.
by Zippy, Chase’s in-house automated loan underwriting system.” The “cheats” and “tricks” listed in the memo are telling. According to the memo, borrowers “MUST have a mid credit score of 700,” and if they are first time homebuyers, they “require a 720 credit score.” In terms of the borrower’s employment history, the memo recommends that borrowers reporting a salary “must have 2 years time on [the] job with current employer.” The memo also instructs those underwriting the loan application to avoid mentioning any assistance a borrower may be receiving on his or her down payment. If all else fails, the memo suggests that one should resubmit the loan application with “slightly higher income.” As the memo states, “Inch it up $500 to see if you can get the findings you want. Do the same for assets.” The memo concludes with the following words of encouragement: “It’s super easy! Give it a try! If you get stuck, call me… I am happy to help!”

At the end of the article, author Jeff Manning calls attention to how the Oregon state regulator “did not have jurisdiction over the federally chartered Chase,” even though the memo was sent by a Chase employee working in a Portland, Oregon. David Tatman, head of Oregon’s Division of Finance and Corporate Securities, affirmed, “It boggles my mind that any federally chartered organization would invite this kind of activity in such a flagrant way.” JPMorgan Chase, like Wells Fargo, ultimately ended

1349 Ibid.
1350 Ibid.
1351 Ibid.
1352 Ibid.
1353 Ibid.
1354 Ibid.
1355 Ibid.
1356 Ibid.
1357 Ibid.
up receiving a $25 billion bailout from the Troubled Asset Relief Program in October of 2008. \footnote{1358}{The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps, 170.}


Although Washington Mutual was modestly involved in subprime mortgage lending throughout most of the 1990’s, the thrift did not move heavily into the market

Looking at Washington Mutual’s profit performance, the thrift made $3.11 billion in profits in 2001 and, just one year later, its profits leaped to $3.9 billion.\footnote{“Washington Mutual 4th-Quarter Net Jumps 15%,” Dow Jones Business News (January 21, 2003).}\footnote{“Washington Mutual’s 4Q Net Fell 21%,” Dow Jones Business News (January 19, 2005).}\footnote{Ibid.} Washington Mutual’s profits in 2002 were never surpassed over the remaining course of the thrift’s existence, but it still posted strong profits of $3.88 billion in 2003.\footnote{According to Eric M. Thorson, Inspector General of the United States Treasury Department, Washington Mutual was eventually undone by a flawed business strategy that started in 2005 when the thrift began originating a heavier volume of Option Adjustable Rate Mortgages. Senator Levin asserted that Washington Mutual adopted this business strategy because the thrift anticipated higher earnings and needed to compete with Countrywide. Please see: Eric M. Thorson, “Statement Before the United States Senate Permanent Subcommittee on Investigations,” 4.} In 2004, Washington Mutual’s year over year profits dropped by nearly 26% to $2.88 billion,\footnote{United States Senate Permanent Subcommittee on Investigations, Wall Street and the Financial Crisis: Anatomy of a Financial Collapse, 48.} which arguably incited the thrift to enter into the subprime mortgage market more aggressively.\footnote{It is important to note that, in 2003, 64% of Washington Mutual’s loan originations were of the fixed-rate, prime variety. By 2006, the percentage of their originations of these safer loans tumbled to only 25%.} It is important to note that, in 2003, 64% of Washington Mutual’s loan originations were of the fixed-rate, prime variety. By 2006, the percentage of their originations of these safer loans tumbled to only 25%.
The thrift’s profits increased 19% to $3.43 billion in 2005, and then increased about 4% in 2006 to $3.56 billion. In 2007, due to massive losses stemming from their subprime mortgage originations, Washington Mutual posted a $67 million loss for the year. Over the course of the first three months of 2008, Washington Mutual lost $1.1 billion and had over $9.2 billion worth of nonperforming loans on its books. Three months later, Washington Mutual recorded a loss of an additional $3.2 billion. About two months later, in September of 2008, the thrift was closed down by the OTS. I will explore some of the ways in which Washington Mutual attempted to present itself to the public as well as examine a few of its subprime lending practices in an effort to provide at least a partial account of why the thrift failed.

In 2003, Kerry Killinger, CEO of Washington Mutual at the time, made a bold announcement: “We hope to do to this industry, what Wal-Mart did to theirs, Starbucks did to theirs, Costco did to theirs… And I think if we’ve done our job, five years from now you’re not going to call us a bank.” Washington Mutual began marketing itself as an “unbank,” striving to send the message: “We’re here, we’re different, we’re not banking as usual.” The thrift elected to call its branches “stores” and outfitted them “with funky décor and music.” It launched lighthearted advertising campaigns designed to differentiate itself from other depositories. For instance, in an effort to show

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1376 Peter S. Goodman and Gretchen Morgenson, “Saying Yes, Wamu Built Empire on Shaky Loans.”
1378 Matthew Creamer, “As Big Banks Grow Bigger, Little Guy Becomes Priority; Consumers are Bread and Butter in Tough Times,” Advertising Age (September 13, 2004).
how customers “loved” their loan officers, Washington Mutual showed an advertisement that “featured an ‘action-teller’ doll, a Ken-like figure complete with [a] cell phone and teller tote bag.” Another advertisement depicted “untrustworthy big banks” stripping “their clients down to their underwear,” only to have “their clothes magically snap back on at Washington Mutual.” Yet another advertisement “showed a bunch of old bankers in pinstripes getting penned up in a corral” by a “hipster guy in a blue work shirt and khakis” because the bankers had “rigid, old-school ideas.” Washington Mutual even considered airing a controversial advertisement invoking suicide, which showed “bankers poised atop a building as if about to jump.” According to one journalist at The Washington Post, Washington Mutual’s advertisements during this time conveyed the idea that the thrift was “selling bank services like others were selling beer or fast food.”

Other advertisements served as harbingers of Washington Mutual’s “unconventional” approach to mortgage lending. A 2002 advertisement featured a character named “Paul” who was “scowling” because the uncertainty of bank loans put him in an irritable mood. However, as the advertisement continues, the viewer learns that “thanks to the ‘flexible lending’ rules on a loan from Washington Mutual, the grumpy Paul can deal with a boot on his car and a bowling ball in the groin and still smile.” The advertisement ends with an announcer stating, “Enjoy your new home,

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1379 Alice Z. Cuneo, “Washington Mutual: Brad Davis.”
1380 “Friendly Fire: Banks Go Light with Summer Ads,” Advertising Age (August 5, 2002).
1381 Barbara Lippert, “We’re Buying Citi But What Has It Been Selling Us?,” The Washington Post (March 1, 2009).
1383 Barbara Lippert, “We’re Buying Citi But What Has It Been Selling Us?”
1384 Ibid.
1385 Ibid.
One has to wonder whether this type of advertising was appropriate for promoting adjustable rate mortgages, a product that is complicated and could potentially pose serious repayment risks to borrowers.

The “Paul” advertisement was part of Washington Mutual’s “The Power of Yes” campaign, underscoring the thrift’s zeal for approving mortgage loan applications. James Vanasek, risk manager at Washington Mutual from 1999 to 2005, stated that the campaign suggested to prospective borrowers that the thrift “would find some way to make a loan.” Fittingly, one advertisement that aired during an Academy Awards’ commercial break on March 23, 2003 showed “customers so confident after their loan applications are approved” that they are willing to order day-old sushi.

In addition to traditional media advertisements, the campaign also included the construction and display of three edifices, each standing alone for three months at a time, in downtown Chicago. For the first three months, passersby would see a cave, for the second three months a log cabin, and for the third three months a “modern home.” The media director for the advertising agency that Washington Mutual hired to build the edifices stated, “We wanted to convey that WaMu could bring any dream you had to a reality.”

Another memorable Washington Mutual advertising campaign, with respect to the way in which it wanted the public to perceive its approach to residential mortgage lending, was its “Whoo hoo!” campaign that it launched in February of 2008, just months

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1386 Ibid.
1389 Aimee Deeken, “Media Plan of the Year: Sedgwick Road,” Adweek (June 23, 2003).
1390 Ibid.
before its failure. The idea behind this campaign, featuring a trademarked “freedom yell straight out of the Simpsons,” according to the Chief Marketing Officer at Washington Mutual at the time, was to help transform the thrift into “an iconic brand that people love” and to demonstrate that it was unsurpassed “when it comes to being emotionally relevant to people.”

Due to a first-rate investigation conducted by the United States Senate Subcommittee on Investigations, the results of which were initially unveiled in April of 2010, and later revised in an April 2011 report, one can be privy to a significant portion of what transpired within the walls of Washington Mutual leading up to its 2008 collapse. The Senate subcommittee’s work painted a vivid picture of both the excessive risks that Washington Mutual assumed before its demise as well as the depository’s dubious relationship with its federal regulator, the OTS.

From 2003 to 2007, “Option ARMs represented nearly half of all of WaMu loan originations” and totaled “approximately $59 billion, or 47 percent, of the home loans on WaMu’s balance sheet at the end of 2007.” In 2006 alone, Washington Mutual “originated more than $42.6 billion in Option ARM loans and sold or securitized at least $115 billion to investors.” Option ARMs, with their various loan repayment options, were nicknamed “pick-a-payment” loans.

In the event that a borrower chooses to pay the minimum monthly payment, an option that is only available for a short period of time

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1391 Barbara Lippert, “We’re Buying Citi But What Has It Been Selling Us?.”
1395 Ibid., 21.
until the loan principle reaches a certain designated threshold, the unpaid interest on the loan is added to the principal, making the loan balance larger.\textsuperscript{1396} Thus, a borrower who receives an Option ARM and elects to only pay the minimum payment will, so long as those reduced payments continue, have a negatively amortizing loan. From 1999 to 2006, Washington Mutual’s “Option ARM borrowers selected the minimum monthly payment more than 95% of the time.”\textsuperscript{1397} At the end of 2007, an astounding 84% of Washington Mutual’s Option ARMs were negatively amortizing.\textsuperscript{1398}

Remarkably, Washington Mutual was permitted to qualify borrowers for Option ARMs based upon their ability to pay merely the minimum monthly payment, as opposed to their ability to make their mortgage payments at the fully indexed rate.\textsuperscript{1399} As an adjustable-rate mortgage, an Option ARM possesses an interest rate that eventually adjusts in relation to a particular index. The fully indexed rate is the rate of the index that the lender chooses plus the percent of the margin that it may add to that index. By adding a margin to their loans, lenders make those loans more profitable for them.\textsuperscript{1400} Failing to qualify borrowers for their mortgages based upon their ability to repay their loans at the fully indexed rate can result in substantially misrepresenting a borrower’s actual repayment ability. After all, for the majority of the repayment period, the borrower will be making monthly loan payments at the fully indexed rate.

Taken alone, Option ARMs are risky mortgage products because of the danger that they can reset at a significantly higher rate. Compounding this risk to an

\textsuperscript{1396} Ibid., 22.
\textsuperscript{1397} Ibid., 59.
\textsuperscript{1398} Ibid.
extraordinary degree is the fact that 73% of the Option ARMs that Washington Mutual originated from 2003 to 2007 were NINA loans, a type of loan that allows borrowers “to simply write-in their income on the loan application without providing supporting documentation.”

NINA loans were originally created for self-employed, “high-income individuals who had income that was hard to document through a W-2,” but somehow were judged by Washington Mutual to be an appropriate loan product for many subprime borrowers. A former Washington Mutual loan consultant conceded that “the big saying” at the company was: “A skinny file is a good file.” At a September 2007 Congressional hearing, Congressman Gary Ackerman nicely brought out the absurdity of mixing subprime loans with NINA loans:

If we had allowed State motor vehicle bureaus to operate and have an independent system of basically unregulated originators of driver’s licenses, and they went out and had advertising to potential drivers who wanted licenses that said, ‘Need a driver’s license, cannot drive? No problem. No test needed. Road rage convictions? Legally blind? Do not worry.’ Then we were shocked to see accidents up and down the highway, most of them involving a lot of good drivers, all caught up in a catastrophic situation.

The acceptability of NINA loans created conditions that were ripe for fraud. For example, one prospective borrower claimed that he had an annual income of six-figures as a mariachi singer. A Washington Mutual supervisor at one of their mortgage processing centers could not verify the applicant’s income, so he requested that the applicant be

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1404 United States House of Representatives Committee on Financial Services, “Recent Events in the Credit and Mortgage Markets and Possible Implications for U.S. Consumers and the Global Economy,” 41.
photographed in front of his home dressed in his mariachi outfit. The loan was approved.¹⁴⁰⁵

A third factor that heightened the risk of Washington Mutual’s lending practices, in addition to offering incredibly risky mortgage products, is the fact that, from 2003 to 2007, between 48% to 70% of their single family loans were purchased from brokers.¹⁴⁰⁶ One would think that since the majority of their risky loans were initially being processed by an outside third party, Washington Mutual would have taken special precautions to ensure that those parties were handling their duties in responsible ways. Yet, in 2007, Washington Mutual devoted only 14 of their employees to oversee more than 34,000 brokers, “an oversight ratio of over 2,400 third party brokers to [every] 1 WaMu employee.”¹⁴⁰⁷ The thrift provided their third-party brokers “with little guidance or training,” other than giving them “daily ‘rate sheets’ explaining the terms of the loans that WaMu was willing to accept and the available commissions.”¹⁴⁰⁸ Long Beach Mortgage Corporation, Washington Mutual’s primary subprime lending operating subsidiary, did not have a single loan officer and obtained all of their subprime mortgages from third-party brokers.¹⁴⁰⁹ At the end of 2007, Washington Mutual announced that they had endured $51 million worth of subprime losses related to fraud committed by third party brokers.¹⁴¹⁰ The thrift’s Chief Risk Officer in 2004 and 2005, James Vanasek, attributed the rampant loan fraud to “compensation incentives that

¹⁴⁰⁵ Peter S. Goodman and Gretchen Morgenson, “Saying Yes, Wamu Built Empire on Shaky Loans.”
¹⁴⁰⁷ Ibid.
¹⁴⁰⁹ Ibid., 75.
¹⁴¹⁰ Ibid., 53.
rewarded loan personnel and mortgage brokers according to the volume of loans they processed rather than the quality of the loans they produced.\textsuperscript{1411}

At this point, one may wonder why Washington Mutual chose to offer Option ARMs and NINA loans, and allow third-party brokers to manage the loan applications for the bulk of their subprime originations. The fundamental answer is that these decisions were, at least for the short-term, \textit{profitable}. Washington Mutual estimated in 2006 that originating Option ARMs was approximately six times more profitable than originating traditional, thirty-year, fixed rate mortgages.\textsuperscript{1412} Originating NINA loans enabled Washington Mutual to earn higher margins of profit, especially when Fannie Mae and Freddie Mac began purchasing them for their retained portfolios in the mid-2000’s.\textsuperscript{1413} Finally, it was roughly 66\% cheaper, a savings of nearly $3,500 per loan, for Washington Mutual to close a loan through a third-broker than it was to close the same loan in-house.\textsuperscript{1414} In January 2005, a proposal was presented to Washington Mutual’s Board of Directors titled “Higher Risk Lending Strategy ‘Asset Allocation Initiative’,” which endorsed a more vigorous subprime lending effort. The executives ultimately adopted the strategy because “high risk home loans were more profitable than low risk loans.”\textsuperscript{1415} Washington Mutual’s chief legal officer from 1997 to 2007 later noted that then-CEO Kerry Killinger’s “view of himself was tied to a constant increase in [WaMu’s] stock price.”\textsuperscript{1416}

\begin{itemize}
  \item \textsuperscript{1411} Ibid., 103. Italics mine.
  \item \textsuperscript{1412} Ibid., 4.
  \item \textsuperscript{1413} Darrel Dochow, “Hearing Before the United States Senate Permanent Subcommittee on Investigations: Wall Street and Financial Crisis, Volume 2.”
  \item \textsuperscript{1414} Eric M. Thorson, “Statement Before the United States Senate Permanent Subcommittee on Investigations,” 5.
  \item \textsuperscript{1415} United States Senate Permanent Subcommittee on Investigations, \textit{Wall Street and the Financial Crisis: Anatomy of a Financial Collapse}, 58.
  \item \textsuperscript{1416} Drew DeSilver, “Part One: Reckless Strategy Doomed WaMu.”
\end{itemize}
One can easily overlook, however, the fact that Option ARMs were not products that “sold themselves” to borrowers and, interestingly enough, were not initially appealing products to loan personnel or mortgage brokers either. As part of Washington Mutual’s Higher Risk Lending Strategy, the thrift had to overcome the difficult challenge of convincing borrowers “to forego a simple, low risk conventional loan in favor of the complex and higher risk Option ARM.”\textsuperscript{1417} This objective implies that the thrift intended to “steer” qualified, prime borrowers away from a fixed-rate, conventional 30-year mortgage to an Option ARM instead. To assist them with this formidable task, Washington Mutual conducted two focus groups in late 2003 to “explore ways to increase sales of Option ARMs” because those loans were the thrift’s “most profitable mortgage loan products.”\textsuperscript{1418}

Among the many findings that were generated by the two focus groups, Washington Mutual learned that “Option ARMs are sold to customers and few walk through the door and ask for them.”\textsuperscript{1419} Furthermore, the thrift claimed that the majority of the participants did not fully understand the Option ARM, though they found that the mortgage product’s “best selling point… was being shown how much lower their monthly payment would be” when one compared the Option ARM to a fixed-rate mortgage loan.\textsuperscript{1420} Washington Mutual also discovered that many of their own salespeople could not understand Option ARMs and, moreover, they had little motivation

\textsuperscript{1418} Ibid.
\textsuperscript{1419} Ibid., 105. Italics mine.
\textsuperscript{1420} Ibid.
to learn more about the mortgage product since it was easier and quicker to sell conventional, fixed-rate loans.\textsuperscript{1421}

Washington Mutual’s solution was to better compensate its loan personnel and third-party brokers for swaying borrowers to Option ARMs. Using an internal alert e-mail system known as “e-Flash,” Washington Mutual would routinely send out messages to its retail sales team announcing “increased compensation incentives for selling Option ARMs.”\textsuperscript{1422} One October 12, 2006 “e-Flash” is particularly worth mentioning. The message announced that a “Fall Kickoff Contest” was now underway. For each of the thirteen weeks of the fourth quarter, “the loan consultant who scored the most points would receive a $100 gift card.”\textsuperscript{1423} At the end of the quarter, the message continued, the top five point winners would receive a $1,000 gift card.\textsuperscript{1424} Every Option ARM sale was counted as “a touchdown” or seven points, while other types of high-risk, subprime mortgages were only “field goals” worth three points.\textsuperscript{1425} Drew DeSilver, writing for \textit{The Seattle Times}, noted that, in 2007, a Washington Mutual loan officer would earn a commission of $1,200 for closing a $300,000 Option ARM, but only earn $960 for closing a traditional fixed-rate loan of the same amount.\textsuperscript{1426}

Washington Mutual was successful in its effort to originate more Option ARMs. In 2003, the lender originated $32.3 billion worth of the loan product, a number that exploded to $68.0 billion in 2004. In 2005, Washington Mutual originated another $64.1 billion worth of Option ARMs, followed by $42.6 billion worth Option ARM loan

\begin{footnotesize}
\begin{itemize}
\item\textsuperscript{1421} Ibid.
\item\textsuperscript{1422} Ibid., 107.
\item\textsuperscript{1423} Ibid.
\item\textsuperscript{1424} Ibid.
\item\textsuperscript{1425} Ibid.
\item\textsuperscript{1426} Drew DeSilver, “Part One: Reckless Strategy Doomed WaMu.”
\end{itemize}
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originations in 2006. One Washington Mutual employee who worked for the lender for over 20 years looked back on this period of time and stated, “I always felt like I worked for a really honest industry that cared for the borrowers they dealt with… [but] the corporate culture changed to: ‘We just want to do the most we can to make money for the bank’.”

Washington Mutual’s endeavor to take on progressively more risks in pursuit of greater profits was accompanied by the marginalization of their own risk managers. An internal newsletter dated October 31, 2005 informed the lender’s risk managers that they needed to “shift (their) ways of thinking” away from acting as a “regulatory burden” on its lending operations and toward being a “customer service” that supported its aggressive growth strategy. James Vanasek, Washington Mutual’s Chief Risk Manager in 2004 and 2005, conceded that the executive management team “very seldom” listened to his calls for a more conservative approach to lending. In an April 2010 hearing, Senator Tom Coburn asked Vanasek whether he ever felt that his opinions were “unwelcomed” at Washington Mutual, to which he responded in the affirmative and stated:

I used to use a phrase. It was a bit of humor or attempted humor. I used to say the world was a very dark and ugly place in reference to subprime loans. I cautioned about subprime loans consistently.

Vanasek sent out a memorandum to Washington Mutual’s Executive Committee on February 24, 2005 declaring, “I fear that the timing of further expansion into higher risk lending… most especially certain new products being considered is ill-timed given the

1428 Drew DeSilver, “Part One: Reckless Strategy Doomed WaMu.”
1430 Ibid.
overheated market and the risk [of] higher interest rates.” 1431 In another memorandum, sent on September 2, 2004, Vanasek warned, “There have been so many warnings of a Housing Bubble that we all tend now to ignore them because thus far it has not happened.” 1432 After admitting that he was not “in the business of forecasting,” he affirmed that he had “a healthy respect for the underlying data,” which indicated that the current lending environment had become “no longer sustainable.” 1433 At the end of the memorandum, he stated, “If the economy stalls, the combination of low FICOs, high LTVs and inordinate numbers of exceptions will come back to haunt us.” 1434 In a later interview, Vanasek revealed that because of his predictions of a collapse in the housing market, his Washington Mutual colleagues gave him the derisive nickname “Dr. Doom.” 1435

Vanasek retired from Washington Mutual in December of 2005 at least partly because the management support for his risk policies and the corporate culture itself was lacking. 1436 Ronald Cathcart, Vanasek’s replacement, stated that when he arrived at Washington Mutual in early 2006, he “inherited a Risk Department that was isolated from the rest of the bank and was struggling to be effective at a time when the mortgage industry was experiencing unprecedented demand for residential mortgage assets.” 1437 In 2008, Cathcart was fired after he took his concerns “about weak controls and rising losses to both the board and to regulators from the Office of Thrift Supervision.” 1438

1431 Ibid., 111.
1432 Ibid., 66.
1433 Ibid.
1434 Ibid.
1435 Ibid.
1436 Ibid., 111.
1437 Ibid.
1438 Floyd Norris, “Eyes Open, WaMu Still Failed.”
3.13. Washington Mutual’s Cozy Relationship With the OTS

While Washington Mutual’s Risk Management Department was unable to effectively mitigate the risks that the thrift felt inclined to take before its failure, its primary federal regulator, the OTS, similarly proved to be unwilling or unable to prevent it from engaging in unsafe and unsound lending practices.\(^{1439}\) The goal of this section is to provide an account of the OTS’ regulatory relationship with Washington Mutual. I will argue that the OTS was, in effect, captured by Washington Mutual, a mortgage lender that became “too big to regulate.”\(^{1440}\) At the outset of this discussion, one should note that, from 2003 and 2007, the OTS spent between 17,000 to 31,000 examination hours at Washington Mutual each year, the equivalent of 8 to 15 full-time employees per year.\(^{1441}\) The deficiencies in their oversight of Washington Mutual were not due to their staff being shorthanded or underfunded.

As a 2011 Senate Subcommittee on Investigations report notes, part of the OTS’ stated mission was “[t]o supervise savings associations and their holding companies in order to maintain their safety and soundness and compliance with consumer laws.”\(^{1442}\) The same report also points out that the “OTS Examination Handbook required ‘[p]roactive regulatory supervision’ with a focus on evaluation of ‘future needs and potential risks to ensure the success of the thrift system in the long term.’”\(^{1443}\) One of the principal tools that the OTS would use to evaluate its thrifts was the CAMELS rating system, a guide that scrutinizes the strength or weakness of depositories in terms of their

\(^{1439}\) Ibid., 162.
\(^{1442}\) Ibid., 167.
\(^{1443}\) Ibid.
“(C) capital adequacy, (A) asset quality, (M) management, (E) earnings, (L) liquidity, and (S) sensitivity to market risk.”\(^{1444}\) The OTS would periodically give each of its thrifts a numerical score for each of those six areas as well as a composite numerical score that was to serve as a representation of their overall safety and soundness. A CAMELS rating of a 1 was the best score, while a 5 was the worst.\(^{1445}\) The OTS would perform these evaluations on their regulated thrifts every 12 to 18 months.\(^{1446}\)

From 2004 to February of 2008, as Washington Mutual engaged in progressively riskier lending practices, the OTS gave the thrift an overall CAMELS score of a 2, which meant that it was “fundamentally sound,” had “satisfactory risk management,” and had “only moderate weaknesses that [were] within the board’s and management’s capability and willingness to correct.”\(^{1447}\) As early as 2004, the United States Treasury Department and the FDIC publicly declared that they felt the rating was inaccurate and inappropriate,\(^{1448}\) and information that was gathered by the Senate Subcommittee on Investigations supports their judgment. For instance, the Senate subcommittee discovered that, from 2004 to 2008, the OTS identified “over 500 serious operational deficiencies” at Washington Mutual and Long Beach Mortgage Corporation.\(^{1449}\) These deficiencies at Washington Mutual included weak lending standards, weak risk management, poor appraisal practices, and poor quality of loans.\(^{1450}\) Despite these observations, the OTS

\(^{1444}\) Ibid.
\(^{1445}\) Ibid. The same report states, “A 1 composite rating in the CAMELS system means ‘sound in every respect’; a 2 rating means ‘fundamentally sound’; a 3 rating means ‘exhibits some degree of supervisory concern in one or more of the component areas’; a 4 rating means ‘generally exhibits unsafe and unsound practices or conditions’; and a 5 rating means ‘exhibits extremely unsafe and unsound practices or conditions’ and is of ‘greatest supervisory concern’.”
\(^{1446}\) Ibid.
\(^{1447}\) Ibid., 228.
\(^{1448}\) Ibid.
\(^{1449}\) Ibid., 209.
\(^{1450}\) Ibid.
never once held internal discussions about taking an enforcement action against Washington Mutual until 2008, around the same time that the regulator decided to finally lower the thrift’s CAMELS rating from a 2 to a 3.\footnote{Ibid.} A number of factors contributed to the OTS’ inaction prior to the failure of Washington Mutual.

First, from 2004 to 2008, the OTS’ biggest “customer,” by far, was Washington Mutual. The thrift paid the OTS an average over $30 million annually, which represented “nearly 15% of the fees per year that paid for [the] OTS’ operating expenses.”\footnote{Ibid., 230.} If Washington Mutual decided to switch charters, a considerable portion of the OTS’ revenue would have been lost. Arguably, Washington Mutual, therefore, had leverage over the OTS, an example of the type of relationship known as “regulatory capture.”\footnote{Wookbai Kim, “A Study on How Regulatory Capture Caused the Subprime Mortgage Crisis and What to Do for Robust Consumer Protection,” 20.} When a regulator gets captured by its regulated corporation, the former tends to privilege the short-term interests of the latter over those of the general public.\footnote{Ibid.}

The Senate subcommittee gathered considerable evidence to substantiate the claim that the OTS was “captured” by Washington Mutual. First, they discovered that the OTS displayed an inappropriate level of deference to the management at Washington Mutual. One OTS regulator publicly stated that his agency provided “by far the softest” oversight of any federal bank regulator.\footnote{United States Senate Permanent Subcommittee on Investigations, \textit{Wall Street and the Financial Crisis: Anatomy of a Financial Collapse}, 210.} An example of this deference was discovered in a January 2006 e-mail sent by the OTS Examiner-in-Charge, Lawrence Carter, who
claimed that the OTS would have to rely on their relationship with Washington Mutual in order to get the firm to act in a way that they deemed prudent.\textsuperscript{1456}

Later that same year, Carter sent out an e-mail that discussed the OTS’ upcoming examination of Washington Mutual. In this e-mail, he stated that the OTS could potentially “run the risk of losing some credibility” if they “pushed too hard on certain reforms.”\textsuperscript{1457} Most telling of all, however, is the OTS’ astonishing decision to allow Washington Mutual to “track its own compliance” with OTS requirements. Using their Enterprise Risk Issue Control System, Washington Mutual was permitted to self-monitor how well they implemented any corrective actions that the OTS prescribed. Washington Mutual was the lone recipient of this OTS-endorsed privilege.\textsuperscript{1458}

The second piece of evidence that the Senate subcommittee supplied in their report, suggesting that the OTS was captured by Washington Mutual, was the fact that the former excused many of the risks that the latter was taking because those risks were, at the time, generating profits.\textsuperscript{1459} A revealing 2005 e-mail, once again sent by Lawrence Carter, disclosed that it was hard for the OTS “to justify doing much more than constantly nagging” Washington Mutual about their excessive risks because the thrift had “not been really adversely impacted in terms of losses.”\textsuperscript{1460} This is precisely the regulatory attitude that the Inspector General of the United States Department of the Treasury, Eric Thorson, uncovered during his review of the OTS and Washington Mutual that ended in 2010. According to Thorson, OTS examiners were aware that Washington Mutual’s “underwriting and risk management practices were less than satisfactory,” but

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\textsuperscript{1456} Ibid., 212.  \\
\textsuperscript{1457} Ibid.  \\
\textsuperscript{1458} Ibid.  \\
\textsuperscript{1459} Ibid., 224.  \\
\textsuperscript{1460} Ibid.
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they did not lower their rating of the thrift’s asset quality because it “was making money and loans were performing.”  

The Senate subcommittee report calls attention, however, to the fact that the OTS handbook explicitly states that “profits should not be used to overlook or excuse high-risk activities.” The same report rightly notes that the role of a regulator is “to enforce rules that ensure the risks an institution undertakes do not unfairly transfer that risk to others or threaten the safety and soundness of the economy, despite any short term profits.” Yet, even as it became more apparent to the OTS that Washington Mutual’s excessive risks were posing grave threats to the thrift’s survival, the OTS did not downgrade its CAMELS rating from a 2 to a 3 until February of 2008. The OTS decided to issue the downgrade shortly after Washington Mutual posted a $1 billion loss in a single quarter, over the course the last three months of 2007. Just before the beginning of that quarter, on September 10, 2007, then-CEO Kerry Killinger declared at a Lehman Brothers conference, “This frankly may be one of the best times I have ever seen for taking on new loans into our portfolio.”

It is a testament to the OTS’ unflappable commitment to deregulation that, after the CAMELS rating downgrade was issued, the regulator did not follow up with any meaningful enforcement actions. Instead, the OTS permitted Washington Mutual to put together its own “nonpublic Board Resolution,” in which the thrift was left to its own

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1463 Ibid., 225.
1464 Ibid., 174.
1465 Ibid.
1466 Drew DeSilver, “Part One: Reckless Strategy Doomed WaMu.”
devices to specify how it would “address various problems.” Ultimately, Washington Mutual did not provide the OTS with “any specific actions or deadlines.” On June 11, 2008, Washington Mutual boasted to its investors that it was not “the target of regulatory actions,” nor was it “currently in such discussions with any regulatory agency,” including the OTS.

In the first half of 2008, Washington Mutual hemorrhaged over $4 billion in losses, which incited the OTS in August of that year to write a Memorandum of Understanding (MOU) to the thrift. In the MOU, the OTS suggested that the thrift improve its lending practices, “develop a capital contingency plan…, submit a 3-year business plan, and engage a consultant to review its underwriting, risk management, [general] management, and board oversight.” Astonishingly, three days after Washington Mutual received the proposed MOU, the thrift had the temerity to ask the OTS “to drop the requirement that the consultant review the Board’s oversight efforts,” a request that the OTS inexplicably granted. The final, agreed-upon MOU was released on September 8 of that year, a little over two weeks before Washington Mutual’s failure. In the MOU, the thrift agreed that it would provide the OTS with “an updated, multi-year business plan and forecast for its earnings, asset quality, capital and business segment performance,” but they would not “raise capital, increase liquidity or make changes to the products and services it provide[d] to customers.” The OTS agreed to those terms.
Three days later, on September 11, the credit rating agency, Moody’s, downgraded the entire Washington Mutual holding company to “junk bond status,” and Standard and Poor’s followed suit within days.\textsuperscript{1474} On September 15, Lehman Brothers filed for bankruptcy, an event that helped fuel Washington Mutual depositors to withdraw approximately $17 billion worth of deposits from the thrift in just eight days.\textsuperscript{1475} On September 18, the OTS reluctantly agreed to downgrade Washington Mutual’s CAMELS rating from a 3 to a 4, indicating, at last, that the thrift was in an unsafe and unsound condition. The fear was so palpable over the ensuing days that the OTS was forced to close down Washington Mutual on Thursday, September 25, unable to wait for Friday, the day of the week on which most banks are closed.\textsuperscript{1476} The FDIC then orchestrated the immediate sale of Washington Mutual to JPMorgan Chase for $1.9 billion.\textsuperscript{1477} Two days later, on September 27, the bank holding company, Washington Mutual, Inc., filed for bankruptcy protection, effectively eliminating the existence of a 119 year old lender that had survived two world wars and the Great Depression.\textsuperscript{1478} Senator Carl Levin’s final assessment of Washington Mutual was that it was “a model of corporate ineptitude, greed, and wrongdoing.”\textsuperscript{1479} One former senior executive at Washington Mutual noted that Killinger “created an atmosphere in which doing the easy thing rather than the hard thing was OK.”\textsuperscript{1480}

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\item \textsuperscript{1474} Ibid.
\item \textsuperscript{1475} United States Senate Permanent Subcommittee on Investigations, \textit{Wall Street and the Financial Crisis: Anatomy of a Financial Collapse}, 58.
\item \textsuperscript{1476} Ibid.
\item \textsuperscript{1477} Ibid.
\item \textsuperscript{1478} Christopher Scinta and Tiffany Kary, “WaMu Filed for Bankruptcy Following FDIC Seizure,” \textit{Bloomberg News} (September 27, 2008).
\item \textsuperscript{1479} Floyd Norris, “Eyes Open, WaMu Still Failed.”
\item \textsuperscript{1480} Drew DeSilver, “Part One: Reckless Strategy Doomed WaMu.”
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JPMorgan and Chase, after analyzing the quality of the $178 billion worth of Washington Mutual mortgage loans that they inherited, “promptly concluded that about two-thirds of them were impaired.” Initially, Chase had to write-down $30 billion worth of Washington Mutual loan-related losses. As of April 2011, the firm had to write-down another $5 billion in losses from the same body of Washington Mutual loans.

In March of 2011, the FDIC announced that it was filing a lawsuit against three former Washington Mutual officials: Chief Executive Officer Kerry Killinger, Chief Operating Officer Stephen Rotella, and the Home Loans Division President David Schneider. In a complaint filed in a Washington federal court, the FDIC accused the three officials of showing “reckless disregard” for the thrift’s safety and soundness and instead focusing “on short-term gains to increase their compensation.” The three officials received over $95 million in compensation from January of 2005 to September of 2008. The FDIC is seeking unspecified damages. Killinger’s lawyers called the suit “baseless and unworthy of the government.”

John Reich, the former Director of the OTS, resigned in late 2008, and stated that his biggest regret was the agency’s inability to curb the origination of NINA loans. Reich, a former banker, conceded that the influx of NINA loan originations at the thrifts that were regulated by the OTS during his tenure had been “abhorrent” to him since he was “raised believing in the fundamental five C’s of credit and fully documented loan

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1481 Floyd Norris, “Eyes Open, WaMu Still Failed.”
1482 Ibid.
1484 Ibid.
1485 Ibid.
1486 Ibid.
1487 Floyd Norris, “Eyes Open, WaMu Still Failed.”
files.” The OTS, at least in part because of the quality of its regulation of Washington Mutual, was abolished by the Dodd-Frank Act of 2010, effective July of 2011.


As the examples of Wells Fargo, Chase Home Finance, and Washington Mutual suggest, “the OCC and OTS were in a state of denial about the grave nature of bank and thrift involvement in reckless lending and the equally grave nature of their own failure to supervise.” All five of the largest national banks under the OCC’s supervision participated in high-risk mortgage lending and weakened the financial condition of their respective parent companies: Bank of America, N.A., JPMorgan Chase, N.A., Citibank, N.A., Wachovia Bank, N.A., and Wells Fargo Bank, N.A. According to the Congressional Oversight Panel, Bank of America ended up receiving $336.1 billion in cash and guarantees from the federal government. According to the same congressional report, JPMorgan Chase ultimately received a federal bailout of $129.6 billion in cash and guarantees. The financial holding company Citigroup, which has Citibank as one of its holdings, ultimately received $476.2 billion in cash and guarantees from the federal government. Company representatives at Citibank later told the SEC that, as they were “conducting risk analyses” of their lending activities and assets, they “had not taken into account the possibility that [their] subprime mortgages would

1489 Floyd Norris, “Eyes Open, WaMu Still Failed.”
1490 Ibid.
1491 The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps, 187.
1492 Ibid., 170-171.
1494 Ibid.
1495 Ibid.
Wachovia was so overwhelmed by the losses caused by its risky nonperforming loans that it was only rescued by “a shotgun marriage” with Wells Fargo near the end of the third quarter of 2008. Finally, Wells Fargo received $107.2 billion in cash and guarantees from the federal government.

In July of 2011, the GAO released a report that summarized their findings after conducting a one-time audit of the Federal Reserve during the period of December 1, 2007 through July 21, 2010. Among the shocking discoveries that were disclosed in the report, the GAO noted that the Federal Reserve lent Citigroup $2.513 trillion, Bank of America $1.344 trillion, JPMorgan Chase $391 billion, Wells Fargo $159 billion, and Wachovia $142 billion during that period of time. The amount of those loans provides an indication of the depths of the institutional and regulatory failure that came to characterize the OCC/lender relationship.

The OTS fared even worse than the OCC in terms of ensuring the safety and soundness of its regulated thrifts. In 2008 alone, five thrifts with assets totaling over $354 billion failed under the OTS’ watch. The next year, in 2009, another twenty OTS-regulated thrifts failed with assets totaling over $50 billion. Among the largest of these thrift failures, aside from Washington Mutual ($307.02 in assets), was IndyMac,
FSB ($30.7 billion in assets) and Downey Savings and Loan ($12.78 billion in assets).\textsuperscript{1503} Patricia McCoy and Kathleen Engel contend that the OTS created a “[regulatory] climate of laxity [that was] unmatched by any other federal banking agency.”\textsuperscript{1504} The two authors note that the irony of the OTS’ failure as a regulator is that the agency was created in 1989 to “clean up” the savings and loan crisis that emerged earlier in that decade.\textsuperscript{1505} We now turn to an examination of the quality of the regulation provided by the other major federal banking regulator, the Fed.

\section*{3.15. The Failure of HOEPA and the Federal Reserve to Sufficiently Regulate Subprime Lenders}

In 1994, Congress “gave the Federal Reserve Board the power to curb unfair or deceptive loans for virtually every mortgage originator in the country.”\textsuperscript{1506} This authority came from the Home Ownership and Equity Protection Act of 1994 (HOEPA), an act that was created in response to the “fledgling subprime market” that was emerging in the early 1990’s.\textsuperscript{1507} Prior to enacting HOEPA, Congress noticed that its existing legislation was inadequately addressing a new array of “abusive terms [and] practices in home mortgages” that subprime lenders were introducing.\textsuperscript{1508}

Broadly speaking, HOEPA consisted of two parts. The first part was designed to regulate certain “high-cost” residential mortgages, a responsibility that was bestowed to the Fed.\textsuperscript{1509} Once a mortgage loan exceeded certain set interest rates or fees, which the Fed established, that loan would be classified as a “high-cost” loan and the lender would

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  \item \textsuperscript{1503} Michael Hudson and Jim Overton, “Special Supplement: The Second S&L Crisis,” 17.
  \item \textsuperscript{1504} \textit{The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps}, 184.
  \item \textsuperscript{1505} Ibid.
  \item \textsuperscript{1506} Ibid., 194.
  \item \textsuperscript{1507} Ibid.
  \item \textsuperscript{1508} Ibid.
  \item \textsuperscript{1509} Ibid.
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be subjected to numerous restrictions.\textsuperscript{1510} The second part of HOEPA came to be known as the UDAP component, which stood for “Unfair and Deceptive Acts and Practices.”\textsuperscript{1511} This portion of the law designated the Fed as the arbiter of what constituted an unfair or deceptive mortgage practice.\textsuperscript{1512}

However well-intentioned Congress was in enacting HOEPA, the act was plagued with at least two crucial weaknesses that eventually undermined its effectiveness in regulating subprime lenders. First, once the Fed determined the parameters of what would be considered a high-cost loan, subprime lenders soon found it easy to avoid having their loans labeled as such by simply charging interest rates and fees that were just below the high-cost threshold.\textsuperscript{1513} Case in point, “the number of subprime loans issued increased after the enactment of HOEPA.”\textsuperscript{1514} After predatory lending abuses became increasingly prevalent in the late 1990’s, the Fed decided in 2001 to revise and expand the reach of their high-cost loan provisions.\textsuperscript{1515} Even after their revised definition of a high-cost loan took effect, approximately 99\% of originated subprime loans evaded the high-cost designation.\textsuperscript{1516}

The second flaw of HOEPA pertained to the UDAP provision in that it was not self-executing.\textsuperscript{1517} In order for the UDAP provision to take effect, for specific types of unfair and deceptive lending practices to be prohibited, the Fed had to issue a rule or

\textsuperscript{1510} Ibid., 194-195.
\textsuperscript{1511} Ibid., 195.
\textsuperscript{1512} Ibid.
\textsuperscript{1513} Ibid.
\textsuperscript{1515} The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps, 195.
\textsuperscript{1516} Ibid.
\textsuperscript{1517} Ibid.
order to activate it.\textsuperscript{1518} Yet, the Chairman of the Fed at the time, Alan Greenspan, categorically refused to implement the UDAP provision.\textsuperscript{1519} Greenspan elected to address subprime abuses by “speeches, consumer literacy, bank examinations, and guidance without binding effect.”\textsuperscript{1520} The Fed was particularly fond of requiring lenders to merely provide borrowers with disclosures about the risks and features of their subprime products, instead of prohibiting lenders from offering certain loan products altogether. Randall Kroszner, part of the Board of Governors of the Federal Reserve, noted during a 2007 hearing before the United States House of Representatives’ Committee on Financial Services that the Fed chose “to focus primarily on addressing potentially unfair and deceptive practices through case-by-case determinations rather than through rulemaking” because properly framed rules are difficult to craft and, moreover, they can potentially prevent legitimate subprime borrowers from having access to mortgage credit.\textsuperscript{1521}

At another hearing before the United States House of Representatives’ Committee on Oversight and Government Reform on October 23, 2008, Congressman John Tierney asked Greenspan why he never activated the UDAP provision.\textsuperscript{1522} Greenspan responded, “[L]et’s take the issue of unfair and deceptive practices… The staff of the Federal Reserve… looks at that statement and then says how do they determine as a regulatory group what is unfair and deceptive?”\textsuperscript{1523} Greenspan estimated that “maybe 10 percent or so” of the practices would be “self-evidently unfair and deceptive,” but the “vast majority

\textsuperscript{1518} Ibid.
\textsuperscript{1519} Ibid.
\textsuperscript{1520} Ibid., 196.
\textsuperscript{1523} Ibid.
would require a jury trial or other means to deal with it.”

Congressman Tierney then interrupted his response, but presumably Greenspan meant that it would be difficult to formulate rules that would restrict unfair and deceptive lending practices and, moreover, the effectiveness of those rules, if implemented, would be highly suspect.

In any event, so unwavering was the Fed’s opposition to activating the UDAP provision that it was not until July 30, 2008, when Federal Reserve Chairman Ben Bernanke, Greenspan’s successor, finally did so. This rule finally prohibited a lender from “making a loan without regard to borrowers’ ability to repay,” required lenders to “verify the income and assets they rely upon to determine repayment ability,” and established “additional advertising standards,” stipulating that lenders must provide “additional information about rates, monthly payments, and other loan features” in their advertisements.

When this rule was initially proposed in April of 2008, the Fed was bombarded by over 5,000 comments from lenders “who said the proposals could affect loans that have not presented problems,” thus limiting their ability to legitimately originate home loans for certain qualified borrowers. Three of the housing industry’s most influential trade groups, the American Bankers Association, the Mortgage Bankers Association and the Independent Community Bankers of America, also criticized the rule when it was proposed. Even as the housing market was falling apart in 2008, participants in the

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1524 Ibid.
1525 The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps, 196.
1528 Ibid.
industry were loath to have federal regulators place stricter limits on mortgage lending practices.

3.16. The Federal Reserve’s Refusal to Regulate Non-Depository Mortgage Lending Affiliates

In 1999, the GAO called attention to the alarming fact that non-depository mortgage lending affiliates within bank holding companies were “not subject to routine examinations by federal regulators for compliance with fair lending and other consumer protection laws and regulations.” In this same report, the GAO noted that consumer and community groups had voiced their concerns over the subprime lending activities of certain non-depository affiliates, particularly how they had “steered” minority loan applicants to more expensive loans. Apprehensive over the growth of non-depository lending affiliates, which “out-paced” every other type of mortgage lender in 1997, the GAO affirmed that the Fed was “uniquely situated to monitor developments in operating relationships among holding company entities that could effect fair lending.” The GAO further stated that the Fed’s role “could be especially valuable in monitoring the lending activity” of non-depository lending affiliates.

Legitimately or not, the GAO noted that the Fed had a long-standing policy of “not routinely conducting consumer compliance examinations” of non-depository lending affiliates that was anchored by three main justifications. First, the Fed correctly noted that

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1529 An affiliate of a corporation or holding company is “a person that controls, is controlled by, or is under common control” with that corporation or holding company. Please see: Robert Charles Clark, “The Regulation of Financial Holding Companies,” *Harvard Law Review*, Vol. 92, No. 4 (February 1979), 790.


1531 Ibid.

1532 Ibid., 20.

1533 Ibid.
while it was the regulator of non-depository lending affiliates, it was not the federal enforcer of violations of fair lending laws.\textsuperscript{1534} The Chairman of the Federal Reserve at the time, Alan Greenspan, put the matter this way: “[I]n January of 1998 the [Federal Reserve] Board concluded that while we have the general legal authority to examine these entities, we have neither the clear enforcement jurisdiction nor the legal responsibility for engaging in such activities.”\textsuperscript{1535} The Fed further announced in January of 1998 that they would not even investigate consumer complaints relating to non-depository lending affiliates.\textsuperscript{1536} The actual enforcement of fair lending violations committed by non-depository lending affiliates was congressionally granted to the Federal Trade Commission (FTC).\textsuperscript{1537}

The second reason that the Fed gave to the GAO for not performing routine examinations of non-depository lending affiliates was that it was expensive.\textsuperscript{1538} The third reason was that, if the Fed began to routinely examine non-depository lending affiliates, it would place those lenders at a competitive disadvantage. Non-depository independent mortgage lenders, which were not part of a holding company, would have a competitive edge over the more heavily regulated non-depository lending affiliates.\textsuperscript{1539}

Since the Fed was the regulator of non-depository lending affiliates, but simultaneously lacked the legal authority to impose sanctions on those lenders, the relationship between the Fed and the FTC took on a special importance before the

\textsuperscript{1534} Ibid., 14.  
\textsuperscript{1537} The United States General Accounting Office, “Large Bank Mergers: Fair Lending Review Could Be Enhanced With Better Coordination.”  
\textsuperscript{1538} Ibid.  
\textsuperscript{1539} Ibid.
subprime mortgage crisis. Unfortunately, in 1999, when the GAO investigated how well the two agencies communicated with one another, they found that the Fed did not typically contact the FTC about whether the agency had any ongoing investigations involving non-depository lending affiliates.1540 The GAO further discovered that the FTC did not examine or routinely investigate non-depository lending affiliates either, nor did they undertake a single enforcement action against non-depository lending affiliates over the course of the previous three years.1541 The GAO concluded that the poor coordination between the two agencies resulted in a lack of regulatory oversight of non-depository lending affiliates.1542

This lack of regulatory oversight of non-depository lending affiliates became more serious after the turn of the century. Over four years after their initial report that accentuated this concern, the GAO brought the matter to light once again in January of 2004. At this point, the GAO noted that non-depository lending affiliates were conducting “a significant amount of subprime mortgage lending.”1543 Over the course of the first six months of 2003, the GAO found that non-depository lending affiliates originated over 24% of all of the subprime mortgages that were originated by the Top 25 subprime lenders over that time.1544 The GAO examined the Department of Housing and Urban Development’s 2001 subprime lender list and discovered that one-fifth of all subprime lenders were non-depository lending affiliates.1545 The agency also mentioned how non-depository lending affiliates were increasingly becoming targets of “federal and

1540 Ibid., 17.
1541 Ibid., 15.
1542 Ibid., 20.
1544 Ibid.
1545 Ibid.
state enforcement actions involving abusive lending.” 1546 Nevertheless, the GAO stated that the Fed apparently still did not have the authority to conduct routine examinations of non-depository lending affiliates “with regard to compliance with consumer protection laws.” 1547 The GAO concluded their report by asserting that was “a need for additional scrutiny and monitoring” of non-depository lending affiliates because of their involvement in subprime lending, and that the Fed was in “an optimal position to play a larger role in such monitoring.” 1548

The Fed’s response to the GAO’s observations is significant. Edward Gramlich, writing on behalf of the Fed, noted that however much merit the GAO’s prescriptions have, the existing regulatory structure “has not been a barrier to Federal Reserve oversight.” 1549 Furthermore, Gramlich reiterated the same argument that Greenspan presented in 1999: if federal law expressly permitted the Federal Reserve to have exclusive or joint enforcement authority over non-depository lending affiliates, those lenders would be burdened by uneven regulation. 1550 That arrangement, in turn, would favor non-depository independent mortgage lenders. 1551 At the end of his statement, Gramlich warned the GAO that increasing the Fed’s regulatory responsibilities would increase costs to the taxpayer. 1552

At the end of 2006, the peak year for subprime lending, one of the largest subprime lenders that year was “regulated,” in the sense just described, by the Fed:

\[\text{\footnotesize 1546 Ibid.} \]
\[\text{\footnotesize 1547 Ibid., 53.} \]
\[\text{\footnotesize 1548 Ibid., 55.} \]
\[\text{\footnotesize 1550 Ibid.} \]
\[\text{\footnotesize 1551 Ibid.} \]
\[\text{\footnotesize 1552 Ibid., 110.} \]
Countrywide Home Loans. According to one source, Countrywide originated over $97 billion worth of subprime loans from 2005 to 2007. A few points about this lender are worth mentioning.

3.17. A Brief Examination of Countrywide, the Largest Subprime Lender, and Its Relationship with the Federal Reserve

One can begin to get a sense of the quality of the Fed’s “regulation” of non-depository mortgage lending affiliates by examining its relationship with Countrywide Home Loans. The Fed was the regulator of this non-depository lending affiliate beginning in 2001 when the parent holding company, Countrywide Financial Corporation, was approved by the Fed to become a bank holding company. In 2001, Countrywide did not offer subprime borrowers loans larger than $400,000 and the maximum loan-to-value ratio of their subprime mortgages was 90%. The non-depository lending affiliate did not feature any interest-only ARMs in its product line at that time and only 13% of their originated loans were of the NINA variety. The only potential recipients of Countrywide NINA loans in 2001 were those borrowers who were self-employed. Still, a journalist writing for The American Banker considered

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1553 The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps, 205.
1554 The Center for Public Integrity, Who’s Behind the Financial Meltdown: The Top 25 Subprime Lenders and Their Wall Street Backers, 14.
1555 For the sake of simplicity, when I speak of Countrywide Home Loans, I am also referring to Full Spectrum Lending, a unit of the Countrywide Financial Corporation holding company that was created in 1996 and devoted to originating subprime mortgages. It is noteworthy that Countrywide did not attach its name to the unit that originated the majority of their subprime loans.
1556 The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps, 200.
1557 Bethany McLean and Joe Nocera, All the Devils are Here: The Hidden History of the Financial Crisis (Penguin: New York, 2010), 226.
1558 Ibid.
1559 Ibid.
Countrywide to be a “big player” in the subprime mortgage market in 2001, while a U.S. Banker article published that same year noted that Countrywide announced that it wanted “to become the dominant player in the subprime business.”

One should note that Countrywide, in 2003, was “regarded with awe in the business world.” In September of that year, Fortune published an article titled, “Meet the 23,000% Stock,” which emphasized how Countrywide was the best performing “financial services company in the Fortune 500” over the previous twenty-one years. That same year, then-CEO of Countrywide, Angelo Mozilo, gave a lecture hosted by Harvard University’s Joint Center for Housing Studies entitled, “The American Dream of Homeownership: From Cliché to Mission.” In this speech, Mozilo “complained that a ‘regulatory mania’ was hurting Countrywide and other ‘reputable’ lenders,” and that overreaching “predatory lending laws… were threatening [to] shut the door to homeownership for hard-working low-income and minority families.”

By 2004, Countrywide forecast that it would have over 325% more “financial centers” and would increase its assets by nearly 250% by the end of 2008. It ended up originating $363 billion worth of mortgages in 2004. Around the beginning of that year, however, Countrywide decided to “make a bigger splash” in the subprime mortgage

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1563 Ibid.
1565 Ibid.
1567 All the Devils are Here: The Hidden History of the Financial Crisis, 144.
As a former Countrywide executive vice president of wholesale lending stated at the time, “[When] you think about Countrywide, you think about fixed-rate loans.” However, he noted that Countrywide was now striving to “redefine” the company’s brand to the point “where when you think Countrywide, you think ARMs.” Later that year, Countrywide launched an advertising campaign that promoted adjustable-rate mortgages. One advertisement consisted of a woman chiding her husband for protesting that they would be unable to afford their home. After the husband admits his mistake, the narrator affirms, “You can count on us.” Other Countrywide slogans included, “No One Can Do What Countrywide Can Do,” “Countrywide Can Show You the Way Home,” and “A Lender That Actually Finds Ways to Make Loans.” Between 2004 and 2006, Countrywide “mailed between six and eight million targeted solicitations each month along with tens of thousands of phone calls.” One individual even received a solicitation from Countrywide through the mail that offered to refinance his post office box.

By June of 2004, Countrywide was offering a bewildering array of 180 loan products. A journalist writing for the publication *The American Banker*, covered a Countrywide investor presentation that month and likened the company’s CEO, Angelo Mozilo, to a “carnival barker,” one who was enthusiastically rattling off the names of

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1569 Ibid.
1570 Ibid.
1573 Ibid.
1575 Ibid., 28. Italic mine.
1576 “A Mortgage for Mice?,” *Consumer Reports*, Vol. 73, No. 9 (September 2008).
1577 Jody Shenn, “ARMed – Not ‘Stuck’.”

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their loans. The article quoted Mozilo as proclaiming, “We have ARMs, one-year ARMs, three-year, five-year, seven- and 10-year. We have interest-only loans, pay-option loans, zero-down programs, low-, no-doc programs, fast-and-easy programs, and subprime loans.” When financial analysts began issuing warnings that the housing market was becoming overheated, Mozilo stated in 2004, “I don’t believe there’s any bubble out there.”

To place Countrywide on a more even footing with their subprime competitors, the company changed the compensation structure for its loan officers. Rather than receive a flat, annual salary, Countrywide’s loan officers “began earning commissions based on [the] volume” of the loans that they brought in to the company. The same American Banker journalist in another article noted that Countrywide previously shunned this form of compensation. Countrywide loan officers were suddenly required to memorize the following script to help bring in more subprime mortgages: “Which would you rather have, a long-term fixed payment or a short-term one that may allow you to realize several hundred dollars a month in savings? I am able to help many of my clients lower their monthly payments and it only takes a few minutes over the phone to get started.” Countrywide’s trademarked low-doc loan product was called “Fast and

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1578 Ibid.
1579 Ibid. I learned about this story from: All the Devils are Here: The Hidden History of the Financial Crisis, 143.
1580 Connie Bruck, “Angelo’s Ashes.”
1581 All the Devils are Here: The Hidden History of the Financial Crisis, 142.
1582 Ibid.
1584 Ibid., 35.
Easy” because the lender could “issue loan approvals without having to wait for pay stubs or income tax returns from applicants.”

In November of 2004, *The Los Angeles Times* reported that the regional vice-president of Countrywide’s subprime lending unit, Shane Pew, sent an e-mail to his team of eighty-five employees that exhorted them to originate more subprime loans. In the e-mail, Pew wrote, “[W]e will not make money if we don’t do Subprime PERIOD.” Pew lamented that his team only brought in 56 subprime mortgages during the previous month. He then proceeded to list ways of steering borrowers, even those with good credit, into subprime loans. These ways included downgrading a borrower’s credit score, “listing only one income when there are two wage earners, increasing the amount of the loan and not listing any of a borrower’s assets.” The e-mail concluded by noting that those were “just a few examples” that the team could use to bring in more subprime loans and that they needed to “think outside the box to make this happen.”

By 2005, Countrywide was also firmly committed to originating Option ARMs. Angelo Mozilo admitted in October of that year that Option ARMs had “recently been portrayed negatively,” but he stated that the product enabled them to “better serve qualified customers looking for a more efficient and flexible way to manage their obligations.” In the third quarter of 2005 alone, Countrywide originated an astounding $29 billion worth of Option ARMs. Incredibly, from 2004 to 2007, the lender

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1585 *The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps*, 37.
1587 Ibid.
1588 Ibid.
1590 Ibid.
originated nearly $750 billion worth of the loan product. By 2007, Countrywide alone was responsible for originating 25% of all the option ARM loans in the country.

Around this same time, however, the dangers of Countrywide’s aggressive, high-risk lending strategy became increasingly difficult to ignore. The lender’s chief risk officer, John McMurray, sent out an e-mail to the chief operating officer of the home loans division, stating, “As a consequence of [Countrywide’s] strategy to have the widest product line in the industry, we are clearly out on the ‘frontier’ in many areas.” By this, McMurray meant that the company now potentially faced “high expected default rates and losses.”

On December 20, 2005, the Fed, OCC, OTS, FDIC, and NCUA issued “proposed interagency guidance on nontraditional mortgage products” in response to their concern that certain loan products, such as Option ARMs and NINA loans, contained elevated risks. In this guidance, the federal regulators made several recommendations, including some that involved the terms of the loans that lenders should offer as well as underwriting standards that lenders should employ.

About three months after the guidance was released, Countrywide sent a letter to the Fed, offering its comments about the regulators’ recommendations. In this letter, Mary Jane Seebach, writing on behalf of Countrywide, asserted that all of the guidance pertaining to loan terms and underwriting standards was unnecessary since federal

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1591 *The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps*, 35.
1592 *All the Devils are Here: The Hidden History of the Financial Crisis*, 228.
1593 Ibid., 144.
1594 Ibid.
1596 Ibid., 15-20.
interagency guidance “already exists for managing real estate lending risk.” Moreover, Seebach maintained that additional regulation of Option ARMs would be excessive because the loan product had “been tested in previous economic cycles” and had proven to be a “fundamentally sound” product. As for NINA loans, Seebach reassured the Fed that Countrywide had sufficient “counterbalancing pricing and underwriting requirements” to ensure the “solid performance” of those loans. Countrywide’s overall resistance to federal regulation was memorably captured by CEO Angelo Mozilo’s bold declaration, “No regulator is going to tell me what kind of products I can offer.”

By 2006, Countrywide “was one of the nation’s biggest originators of pay-option ARMs, the second-largest originator of interest-only loans, and the third-largest originator of low-doc and no-doc loans.” The lender now offered subprime loans in amounts as large as $1 million. They were offering NINA loans to borrowers who classified themselves as “wage earners” and could process their loan applications “in as little as thirty minutes.” Countrywide also offered interest-only loans to borrowers with FICO scores as low as 560. As Bethany McLean and Joe Nocera write, it was “hard to imagine anyone who wouldn’t qualify for a Countrywide subprime loan during the final throes of the housing bubble.”

1598 Ibid., 2.
1599 Ibid., 5.
1600 All the Devils are Here: The Hidden History of the Financial Crisis, 149.
1601 The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps, 200.
1602 All the Devils are Here: The Hidden History of the Financial Crisis, 226.
1603 The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps, 200-201.
1604 Ibid.
1605 All the Devils are Here: The Hidden History of the Financial Crisis, 226. Italics theirs.
Insurance Company, a firm that had insured a large portion of Countrywide’s risky loans, revealed that Countrywide’s risk officers were aware that their company was overstating the income of its borrowers by over 50% on at least a third of their mortgage applications.\footnote{1606 \textit{Ibid.}, 228.}

Countrywide’s collapse was swift. By the end of 2007, one out of three of their subprime loans were delinquent and the lender posted an annual loss of $704 million, its first annual loss in over thirty years.\footnote{1607 \textit{Kate Berry, “Countrywide Loss Aside, BofA Calls Deal ‘a Go’,” The American Banker, Vol. 173, No. 20 (January 30, 2008).}} Perhaps out of a concern of impending lawsuits, the lender agreed to help borrowers restructure an astonishing $16 billion worth of Countrywide-originated mortgages.\footnote{1608 \textit{Bob Tedeschi, “New Help With Foreclosures,” The New York Times (October 28, 2007).}} Earlier that year, Countrywide CEO Angelo Mozilo attempted to persuade executives of large investment banks in New York to continue financing their risky loans, but they refused.\footnote{1609 \textit{Connie Bruck, “Angelo’s Ashes.”}} In a panic, Countrywide contacted over forty banks and tapped into $11.5 billion worth of loans from pre-established lines of credit to stay afloat.\footnote{1610 \textit{Ibid.}} In December of 2007, Mozilo considered selling the company. On January 11, 2008, Bank of America announced that it would purchase Countrywide for $4 billion, a fraction of the amount of the company’s market value before the subprime crisis erupted.\footnote{1611 \textit{Ibid.}} Countrywide ceased originating subprime mortgages altogether by that time.\footnote{1612 \textit{Kate Berry, “Countrywide Foreclosure Spike,” The American Banker, Vol. 173, No. 51 (March 14, 2008).}} From January 26, 2007 to January 31, 2008, Countrywide’s stock price went from $45.26 to $6.96, a decline in value of 84.6%.\footnote{1613 \textit{The Center for Responsible Lending, “Unfair and Unsafe: How Countrywide’s Irresponsible Practices Have Harmed Borrowers and Shareholders,” CRL Issue Paper (February 7, 2008), available at}}
few months later, Countrywide ended up posting a loss of $893 million over the first quarter of 2008. An analyst later asked Mozilo if, in hindsight, he would have handled the company differently now that the dangers of subprime mortgages are more readily apparent. In an extraordinary confession of regret, Mozilo replied that “theoretically” he would have made different decisions, but he added, “Our volumes, our whole place in the industry, would have changed dramatically, because we would have arbitrarily made a decision that was contrary to what everything appeared to be… It would have been an insight that only, I think, a superior spirit could have had at the time.”

In the summer of 2008, an imbroglio erupted when reports surfaced that Countrywide had placed certain “high profile figures” in what the lender called “The Friends of Angelo” program. The program gave these select men, including Senators Christopher Dodd and Kent Conrad, as well as former Fannie Mae CEO’s Franklin Raines and Jim Johnson, V.I.P. loans that contained favorable rates that were not available to other customers. Congressman Darrell Issa, Chairman of the House Oversight Committee, issued a subpoena to Bank of America to acquire all materials related to the Friends of Angelo program, claiming that Countrywide “orchestrated a deliberate and calculated effort to use relationships with people in high places in order to manipulate public policy and further their bottom line.” That same summer, Mozilo accidentally replied to an e-mail from a borrower who requested that his loan be modified

1614 The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps, 92.
1615 Connie Bruck, “Angelo’s Ashes.”
1617 Connie Bruck, “Angelo’s Ashes.”
in order to avoid foreclosure. Mozilo inadvertently sent an e-mail to the borrower that indicated that he found the request to be “disgusting” and “unbelievable.”

Mozilo’s image was tarnished even further when, in the summer of 2009, the Securities and Exchange Commission (SEC) charged him with committing fraud and “insider trading for alleged stock sales” before Countrywide collapsed. In particular, the SEC alleged that Mozilo “unloaded his [Countrywide] stock while knowing the risks facing the company, resulting in proceeds of $140 million.” The SEC eventually dropped the suit in March of 2011 when Mozilo agreed to pay $22.5 million in penalties “without admitting or denying the accusations.” To put this number in perspective, one should note that Mozilo received $23.6 million in compensation in 2003 alone. After the collapse of his company, Mozilo told Congressional examiners in September of 2010 that “Countrywide was one of the greatest companies in the history of this country.”

As for Bank of America, its acquisition of Countrywide continues to haunt the bank. In October of 2008, Bank of America promised Countrywide borrowers that it would modify over $8 billion worth of their loans. The next year, in February of 2009, Bank of America announced that it was changing Countrywide’s name to “Bank of America Home Loans” because it was concerned that “the brand image of

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1621 Ibid.
1623 All the Devils are Here: The Hidden History of the Financial Crisis, 141.
1625 Connie Bruck, “Angelo’s Ashes.”
Countrywide… would be less appealing to customers.” In June of 2010, the bank agreed to pay the Federal Trade Commission $108 million “to cover foreclosure-related servicing abuses by Countrywide.” At the end of 2010, Bank of America paid Fannie Mae $1.52 billion and Freddie Mac $1.28 billion to end claims related to mortgages that Countrywide originated between 2004 and 2008. A few months later, the bank arrived at a $1.6 billion settlement with Assured Guaranty to resolve claims stemming from Countrywide’s poor lending standards. In an effort to distance itself from the fallout of the mortgage crisis, Bank of America chose to create an entity known as “Legacy Asset Servicing,” which it will use to handle over 1.3 million troubled mortgage loans, the majority of which were originated by Countrywide.

As of May of 2011, Bank of America’s home loan division has suffered losses of over $15 billion since it acquired Countrywide. According to Dan Fitzpatrick, writing for *The Wall Street Journal*, as of July of 2012 the Countrywide acquisition has cost Bank of America over “$40 billion in real-estate losses, legal expenses and settlements with state and federal agencies.” In late June of 2011, Bank of America agreed to settle with 22 investment companies that were holding a combined 530 soured mortgage pools that were issued by Countrywide. The unpaid principal amount of the mortgage

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1626 “Bank of America Planning to Drop Countrywide Name,” *Global Banking News* (February 20, 2009).
pools involved in the settlement was an astounding $174 billion, though Bank of America agreed to settle for $8.5 billion. A final hearing to approve the settlement was scheduled for November 17, 2011.1633

On October 24, 2012, the United States Justice Department filed a lawsuit against Bank of America “to recover damages and penalties arising from a scheme to defraud” Fannie Mae and Freddie Mac.1634 According to the lawsuit, as mortgage defaults surged across the country in 2007, Countrywide unveiled a new “streamlined” loan origination model that it named the “Hustle” or “HSSL,” which stood for “high speed swim lane.”1635 This new model was designed to have loans “move forward and never backward” and to “remove unnecessary ‘toll gates’ [that were] slowing down the loan origination process.”1636 The lawsuit alleges that Countrywide’s Hustle “eliminated underwriter review [for] even many high risk loans.”1637 Critical underwriting tasks were assigned to “loan processors who were previously considered underqualified even to answer borrower questions.”1638 Instructions on how to perform underwriting tasks were eliminated under the Hustle model and “considered nothing more than unnecessary forms that would slow down the swim lane.”1639 Furthermore, the lawsuit accuses Countrywide

1635 Ibid., 2-3.
1636 Ibid., 3.
1637 Ibid.
1638 Ibid.
1639 Ibid.
of revamping “the compensation structure of those involved in loan origination, basing performance bonuses solely on volume.”

The Justice Department claims that Countrywide’s own quality control reports on Hustle loans found material defects, such as fraud and other qualities that would make loans ineligible for sale to investors, as high as 40% during certain months, which was ten-times higher than the industry standard defect rate. Not only did Countrywide fail to discontinue the Hustle program in light of this information, the Justice Department maintains that it elected to offer one-time bonuses to their quality control employees to “rebut” the defect findings for the sake of making the defect rates “appear lower to investors.” The Justice Department “seeks the maximum amount of damages and the maximum amount of civil penalties allowed by law.”

Leading up to the subprime mortgage crisis, no mortgage lender originated more risky loans than Countrywide. From 2003 to 2007, Countrywide was consistently ranked in the Top 4 of National Mortgage News’ annual “Top Subprime Lenders” list. As Patricia McCoy and Kathleen Engel ask, “While Countrywide was spewing out hundreds of billions of dollars in toxic loans, where was the Fed?” Interestingly, the Fed’s “oversight of Countrywide was confidential and thus hidden from view.” However, given that the Fed had a “formal policy” that relieved them from both “routinely conducting consumer compliance examinations” of non-depository lending affiliates of

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1640 Ibid., 4.
1641 Ibid.
1642 Ibid., 5.
1643 Ibid.
1645 The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps, 201.
1646 Ibid.
bank holding companies as well as “investigating consumer complaints” relating to those lenders, one may reasonably cast doubt on whether it ever examined Countrywide at all. Even if the Fed did in fact regularly examine Countrywide, it is important to note that in this case, the Fed did not bring the company’s “disastrous lending” to a halt. An additional significant point about the Fed’s “regulation” of Countrywide is that the former never once took formal enforcement action against the latter. Indeed, the Fed never took a single enforcement action against any non-depository mortgage lending affiliate between 2003 and 2007, true to its established policy.

Prior to the outbreak of the subprime mortgage crisis, former Federal Reserve Chairman Alan Greenspan was “philosophically opposed to heavy-handed intervention of rule making,” adhering to the belief that “government regulation squelches private responsibility and initiative.” Instead, Greenspan felt that lenders would avoid taking excessive risks “in the interest of self-preservation.” Federal Reserve officials, in general, agreed with Greenspan on this issue, noting further that “over-zealous regulation might cut off credit to people who need it most.” Richmond Fed President, Jeffrey Lacker, once asserted, “There is going to be a fraction of people that get the wrong [loan] product and that is regrettable,” but if the Fed did something to “limit that probability,”

1648 Ibid.
1649 The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps, 201.
1650 Ibid.
1651 Ibid.
1654 The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps, 190.
1655 Ibid., 192.
1656 Craig Torres and Alison Vekshin, “Fed, OCC Publicly Chastised Few Lenders During Boom.”
they could potentially be limiting “credit to people for whom that is the right product.”

During a hearing before the United States House of Representatives’ Committee on Oversight and Government Reform on October 23, 2008, Congressman Henry Waxman questioned Greenspan’s underlying belief that “free, competitive markets are by far the unrivaled way to organize economies” and that no regulation has ever “meaningfully worked” in the past. When pressed by Congressman Waxman to consider whether the havoc that the subprime mortgage crisis wreaked on the economy casted doubt on the accuracy of that opinion, Greenspan memorably admitted that the crisis caused him to find a flaw in his belief system, one that he held on to “for over 40 years,” and that he was “very distressed by that fact.” Congressman Waxman then asked Greenspan to clarify what he meant by “a flaw,” to which Greenspan responded that he found a flaw in the model that he perceived was the “critical functioning structure that defines how the world works.” He stated that he was “in a state of shocked disbelief” that the self-interest of mortgage lending institutions did not have the efficacy to “protect shareholders equity.” Finally, as much as he “would have preferred otherwise,” Greenspan uncharacteristically called for a number of “regulatory changes,” which he believed would ultimately contribute to America reemerging “with a far sounder financial system.”

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1657 Ibid.
1659 Ibid.
1660 Ibid.
1661 Ibid., 12.
1662 Ibid.
3.18. Non-depository Independent Mortgage Lenders and State Banking Regulators

Thus far, three lender/regulator relationships have been examined: the OCC and their federally chartered national banks (and their non-depository mortgage lending subsidiaries), the OTS and their federally chartered thrifts (and their non-depository mortgage lending subsidiaries), and the Fed and their non-depository mortgage lending affiliates. The fourth and final regulatory relationship that needs to be explored, along with its bearing on the subprime mortgage crisis, is the relationship between individual state banking regulators and non-depository independent mortgage lenders, those companies that are not part of a holding company.

Since there are fifty state banking regulators, each with their own laws and licensing requirements for non-depository independent mortgage lenders, I am forced to discuss this regulatory relationship in general terms. By and large, non-depository independent mortgage lenders escape federal banking regulation, but they have to “comply with state laws, except for state provisions preempted by the Depository Institutions Deregulation and Monetary Control Act (DIDA) and the Alternative Mortgage Transactions Parity Act (AMTPA).”¹⁶⁶³ Non-depository independent mortgage lenders are not regularly examined by any federal agency,¹⁶⁶⁴ which entails that they are not subject to fair lending, soundness and soundness, and other types of federal

¹⁶⁶³ Patricia A. McCoy, Elizabeth Renuart, “The Legal Infrastructure of Subprime and Nontraditional Home Mortgages,” 14.
assessments. In addition, these independent lenders do not have to meet federally-established minimum risk-based capital requirements and reserve requirements.

Instead, non-depository independent mortgage lenders need to meet individual state requirements in order to lawfully conduct business within that state. For instance, state licensing requirements generally demand that non-depository independent mortgage lenders meet certain experience, education, and operations requirements in order to engage in mortgage activities. States may also examine independent lenders “to ensure compliance with licensing requirements, review their lending… functions, and look for unfair or unethical business practices.” In the event that a state regulator discovers that an independent lender has been engaging in those latter practices, some state attorneys general “may pursue actions that include license suspension or revocation, monetary fines, and lawsuits.”

All fifty states additionally have their own UDAP laws. State UDAP laws “contain a variety of restrictions on public enforcement,” and the limits themselves “vary widely among the states.” Some states, for instance, forbid their attorneys general from bringing any actions against mortgage lenders. Other states “prevent attorney general actions if the target of the action is an entity regulated by another state or federal

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1665 Patricia A. McCoy, Elizabeth Renuart, “The Legal Infrastructure of Subprime and Nontraditional Home Mortgages,” 14.
1666 Ibid.
1668 Ibid., 6.
1669 Ibid.
1671 Ibid.
1672 Ibid., 293.
agency."\textsuperscript{1673} How well a non-depository independent lender is regulated in any given state depends upon the reach of the state’s lending laws as well as its ability to enforce those laws.\textsuperscript{1674} According to Prentiss Cox, a former Assistant Attorney General in Minnesota, states with a “central UDAP focus were the only regulators or organizations that made substantial efforts to identify and address rampantly imprudent mortgage lending practices” during the explosion of the subprime market.\textsuperscript{1675}

Nevertheless, leading up to the subprime mortgage crisis, state regulatory enforcement of mortgage lending and consumer law violations committed by independent leaders was generally “very weak.”\textsuperscript{1676} One study explored the strength of state subprime lending regulations in Florida, California, Minnesota, and Oregon. The author of the study concluded, “Overall, none of these states have subprime loan regulations in place that adequately protect borrowers.”\textsuperscript{1677} Furthermore, compared to their federal regulator counterparts, state regulators tended to be ill-equipped and underfunded for performing time-consuming, costly examinations of independent lenders that were operating in their state lines.\textsuperscript{1678} The widely-publicized $325 million predatory lending settlement with Ameriquest in 2006, for instance, was the product of a two-year investigation conducted by 49 states, and a one-year negotiation on the terms of the agreement.\textsuperscript{1679}

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\textsuperscript{1673} Ibid.
\textsuperscript{1674} Patricia A. McCoy, Elizabeth Renuart, “The Legal Infrastructure of Subprime and Nontraditional Home Mortgages,” 14.
\textsuperscript{1675} Prentiss Cox, “The Importance of Deceptive Practice Enforcement in Financial Institution Regulation,” 300.
\textsuperscript{1676} Dan Immergluck, Foreclosed: High-Risk Lending, Deregulation, and the Undermining of America’s Mortgage Market, 77. A notable exception to this assertion was when, in 2006, 49 states settled into a $325 million settlement with the independent mortgage lender, Ameriquest. Please see: Eliot Spitzer, “Predatory Lenders’ Partner in Crime,” The Washington Post (February 14, 2008).
\textsuperscript{1677} Rayth T. Myers, “Foreclosing on the Subprime Loan Crisis: Why Current Regulations are Flawed and What is Needed to Stop Another Crisis From Occurring,” 331.
\textsuperscript{1678} Ibid.
\end{multicols}
\end{footnotesize}
The FTC was the only federal agency that was authorized to assist state regulators with their examination efforts, but it, too, lacked sufficient staff and enforcement capacity. Prentiss Cox maintains that federal regulators like the Fed and OCC “were totally uninterested in looking on the ground at what was happening to actual human beings.” In terms of overseeing non-depository independent mortgage lenders, Cox noted that the individual state attorneys general “were the only cops on the beat.”

To provide a sense of the inability of state regulators to effectively oversee the independent mortgage lenders that were operating within their state lines, one should consider the fact that 169 of those lenders failed in 2007 alone. According to data provided by The Center for Public Integrity, the second and third largest subprime originators from 2005 to 2007 were non-depository independent mortgage lenders: Ameriquest (#2) and New Century Financial Corporation (#3). Given the extent of their involvement in subprime mortgage lending leading up to the crisis, it is important to provide a brief sketch of both of these lenders as well as examine some of the key decisions that they made before the subprime market collapsed.

1680 Dan Immergluck, *Foreclosed: High-Risk Lending, Deregulation, and the Undermining of America’s Mortgage Market*, 77
1681 *All the Devils are Here: The Hidden History of the Financial Crisis*, 205.
1682 Ibid.
1684 When I speak of Ameriquest, I am referring to both of its lending units: Ameriquest Mortgage Corporation and Argent Mortgage Corporation. The former tended make direct loans to borrowers, while the latter originated loans through brokers. Please see: Mike Hudson and E. Scott Reckard, “Workers Say Lender Ran ‘Boiler Rooms’,” *The Los Angeles Times* (February 4, 2005), *available at* http://www.latimes.com/business/la-fi-ameriquest4feb0405,0,1989146.story.
3.19. Ameriquest: The Second Largest Subprime Mortgage Lender

Ameriquest Capital, founded in 1979 as Long Beach Savings and Loan,\textsuperscript{1686} was the largest originator of subprime loans in 2003,\textsuperscript{1687} an accomplishment that the company once again enjoyed in 2004\textsuperscript{1688} and 2005\textsuperscript{1689} as well. It is noteworthy that one of the main reasons that the lender changed its name from Long Beach Mortgage to Ameriquest was because, in 1996, the United States Justice Department accused it of gouging elderly, female, and minority borrowers, charging them fees as high as 12\% of the loan amount. The lender ended up settling with the Justice Department for $4 million.\textsuperscript{1690}

Leading up to the subprime mortgage crisis, Ameriquest attempted to restore its reputation by publicly announcing in 2000 that it would adhere to an “innovative” list of “best practices.” Ameriquest executives declared that its “procedures and internal controls” were now designed to ensure that their “underwriting standards, pricing policies, and property valuations [were] fair and accurate.”\textsuperscript{1691} The executives also maintained that Ameriquest held itself “to the highest standards” and would “not tolerate unethical or improper behavior” by its employees.\textsuperscript{1692}

Another way that Ameriquest attempted to repair its reputation in 2000 was by forming an alliance with the Association of Community Organizations for Reform Now (ACORN). The lender arrived at an agreement with ACORN that involved the creation of a $360 million, three-year residential pilot program in 10 cities, designed to “provide potential homebuyers in low-income neighborhoods with counseling and access to

\begin{thebibliography}{9}
\bibitem{1686} Mike Hudson and E. Scott Reckard, “Workers Say Lender Ran ‘Boiler Rooms’.”
\bibitem{1688} Ibid.
\bibitem{1690} Mike Hudson and E. Scott Reckard, “Workers Say Lender Ran ‘Boiler Rooms’.”
\bibitem{1691} Ibid.
\bibitem{1692} Ibid.
\end{thebibliography}
loans.” An executive of Ameriquest at the time, Kirk Langs, assured the public that Ameriquest was not using the alliance “as a sales tool” or as a way “to pump up business in any way.” One should note that ACORN later revealed that Ameriquest “made only a small fraction of those loans” because the group located other lenders that were “offering better terms for [its] community residents.”

Striving to put their image problems behind them, Ameriquest “embarked on an all-out marketing offensive” in the early 2000’s that included the purchase of two blimps that hovered over major sporting events. In a press release, the vice chairman of Ameriquest at the time, Adam Bass, stated that the blimps served “as highly visible symbols our desire to help every American fulfill their dream of homeownership.” Ameriquest also reached an agreement with the Texas Rangers to have the team’s home baseball stadium renamed “Ameriquest Field,” in exchange for $75 million to be paid out over the course of thirty years. Included in the agreement was the provision that the lender’s logo, the Liberty Bell, would “clang” every time a Ranger’s player hit a homerun. Soon after the naming-rights announcement was made, Bass stated that the agreement matched “the American dream for homeownership with the American pastime.” He added, “Baseball is a game for the entire family, and homeownership is the ultimate family occurrence.”

1694 Ibid.
1695 Mike Hudson and E. Scott Reckard, “Workers Say Lender Ran ‘Boiler Rooms’.”
1696 “Ameriquest Takes to the Skies in Airship Liberty,” Origination News, Vol. 14, No. 3 (December 4, 2004). The two blimps were named “Ameriquest Airship Liberty” and “Ameriquest Airship Freedom.”
1697 Ibid.
1699 Ibid.
1700 Ibid.
1701 Ibid.
In February of 2005, Ameriquest paid roughly $15 million to sponsor the Super Bowl halftime show that featured a performance by Paul McCartney.\textsuperscript{1702} The lender also paid approximately $4 million later that year to sponsor The Rolling Stone’s “On Stage Tour” that launched in August. Part of the promotion of the tour included the slogan: “Ameriquest: Not your average mortgage company. Rolling Stones? Not your average garage band.”\textsuperscript{1703} At one point, Ameriquest was the official mortgage sponsor of both the National Football League and Major League Baseball.\textsuperscript{1704} The lender even went so far as to dub itself: “A proud sponsor of the American Dream.”\textsuperscript{1705}

As Ameriquest was rehabilitating its image in the early 2000’s, the lender simultaneously experienced phenomenal growth. In just four years, from 2001 to 2004, Ameriquest’s subprime loan production grew more than twelvefold, reaching as high as $82.7 billion in 2004.\textsuperscript{1706} By 2005, the lender had over 12,000 employees working at 298 branches in 38 states.\textsuperscript{1707}

Throughout this period of time, however, Ameriquest was embroiled in a number of state lawsuits and entangled in several investigations. On January 22, 2004, Ameriquest agreed to a settlement of over $600,000 with the state of Connecticut for resoliciting “customers too soon for refinancing.”\textsuperscript{1708} When the same problems resurfaced just months after the settlement, the state of Connecticut threatened to take away

\begin{footnotesize}
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\item \textsuperscript{1703} Lucy Berrington and Jeff Onore, “19th Nervous Meltdown,” \textit{The Guardian} (October 10, 2008), available at http://www.guardian.co.uk/commentisfree/cifamerica/2008/oct/10/rolling-stones-credit-crunch-ameriquest.
\item \textsuperscript{1704} “Ameriquest Takes to the Skies in Airship Liberty.”
\item \textsuperscript{1707} Mike Hudson and E. Scott Reckard, “Workers Say Lender Ran ‘Boiler Rooms’.”
\item \textsuperscript{1708} Erick Bergquist, “Under Scrutiny, Ameriquest Details Procedures.”
\end{itemize}
\end{footnotesize}
Ameriquest’s license.\textsuperscript{1709} At the same time, Ameriquest was in the midst of settling a four-state lawsuit in California centering on its lending abuses and a two-state lawsuit in Florida.\textsuperscript{1710}

From 2000 to 2004, Ameriquest customers filed over four times the amount of complaints with the FTC than the customers of Countrywide over that period of time.\textsuperscript{1711} The majority of those complaints accused Ameriquest of inflating the values of homes, encouraging borrowers to misrepresent their income or employment status, and misleading borrowers about the fees imbedded in their loans.\textsuperscript{1712} Mark Bomchill, a loan officer at Ameriquest from 2002 to 2003, admitted that his employee training program centered on promoting the idea that their loans were providing benefits to the customer, “which in reality didn't exist in the long run.”\textsuperscript{1713} Bomchill further conceded that they were trained how to coach borrowers into believing that higher loan readjustments were not forthcoming, and to omit mentioning “the tremendously high fees” that were accompanying their loans.\textsuperscript{1714}

Ameriquest was also notorious for employing bait-and-switch techniques, promising certain interest rates and fees to borrowers, but then changing them at the time of closing.\textsuperscript{1715} One former Ameriquest employee asserted that the lender did not “have the customer’s best interest in mind at all” and that its dominant approach to mortgage lending was “all about making the dollar and dealing with the consequences later.”\textsuperscript{1716}

\textsuperscript{1709} Ibid.
\textsuperscript{1710} Ibid.
\textsuperscript{1711} Mike Hudson and E. Scott Reckard, “Workers Say Lender Ran ‘Boiler Rooms’.,” \textit{All the Devils are Here: The Hidden History of the Financial Crisis}, 205.
\textsuperscript{1713} Ibid.
\textsuperscript{1714} Ibid.
\textsuperscript{1715} Mike Hudson and E. Scott Reckard, “Workers Say Lender Ran ‘Boiler Rooms’.,”
\textsuperscript{1716} Ibid.
Another former employee confessed that she “witnessed documents being altered… [by way of] co-workers using a brightly lighted Coke machine as a tracing board, copying borrowers' signatures on an unsigned piece of paper.” ¹⁷¹⁷

After a two year investigation of Ameriquest, orchestrated by a committee of five states, the lender agreed to a $325 million settlement in January of 2006 without admitting any wrongdoing. ¹⁷¹⁸ According to the committee, Ameriquest created a “hyper-aggressive, high pressure” sales culture that “encouraged its sales personnel to engage in deceptive and fraudulent conduct.” ¹⁷¹⁹ The committee discovered that Ameriquest concealed interest rate and loan costs from borrowers during the application process, provided inaccurate good faith estimates to borrowers, falsified loan documents to push through loans, and charged “thousands of dollars in discount points that resulted in higher commissions for sales personnel but failed to yield a lower interest rate for borrowers.” ¹⁷²⁰ One should note that the settlement did not include the placement of any restrictions or limitations on Ameriquest’s state licenses. ¹⁷²¹

Five months after the settlement was reached, Ameriquest elected to close down all of its retail branches and eliminate 3,800 jobs. ¹⁷²² Its new business strategy was to conduct all of its operations in four large regional call centers. ¹⁷²³ The lender announced

¹⁷¹⁷ Ibid.
¹⁷²⁰ Ibid.
¹⁷²¹ “Canary in the Mortgage Mess: Former Ameriquest Employee Calls for Reform.”
¹⁷²² All the Devils are Here: The Hidden History of the Financial Crisis, 207.
¹⁷²³ Ibid.
that it anticipated “that its retail origination volume will fall dramatically for three to six months,” but then it expected its “production volumes to rise significantly.”

As Bethany McLean and Joe Nocera observe, however, “Ameriquest never really recovered from the settlement.” By the end of 2006, Ameriquest was experiencing a dramatic decrease in earnings and was searching for a buyer. Massachusetts governor Deval Patrick, a former director of Ameriquest’s board, made a call on February 20, 2007 to Citigroup, personally vouching for “the current management and the character of the company.” Eight days later, on February 28, Ameriquest reached an agreement with Citigroup that put fresh working capital into the ailing lender.

In September of 2007, the OCC approved the purchase of Ameriquest’s subprime lending unit, Argent Mortgage, by Citibank, N.A. Citibank immediately renamed the acquired lending unit “Citi Residential Lending” to distance itself from Ameriquest’s tarnished reputation. In just eight months, in May of 2008, Citi Residential Lending had to shut down its operations due in large part to the overwhelmingly poor quality of Argent’s subprime loans. By the fall of 2008, Ameriquest completely closed down and Citigroup “took over the $45 billion portfolio of loans that needed to be serviced.”

1725 All the Devils are Here: The Hidden History of the Financial Crisis, 207.
1726 Ibid., 208.
1728 All the Devils are Here: The Hidden History of the Financial Crisis, 208.
1729 The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps, 170.
1730 Ibid.
1731 Ibid.
1732 All the Devils are Here: The Hidden History of the Financial Crisis, 208.
It is in this context that Citigroup received $476.2 billion in cash and guarantees from the federal government.\textsuperscript{1733}

### 3.20. The Rise and Collapse of New Century Financial

New Century Financial Corporation was one of a handful of publicly traded subprime lenders that survived the first subprime crisis that erupted in 1998. After posting annual losses in 1999 and 2000, New Century turned a significant corner and posted a profit of $48 million in 2001.\textsuperscript{1734} The New Century Chairman and CEO at the time, Robert Cole, gave credit to its loan origination system, Fastqual, for contributing to much of the lender’s recent success.\textsuperscript{1735} Fastqual could approve loan applications in twelve seconds.\textsuperscript{1736}

After the 2001 earnings announcement, Cole underscored how twenty other subprime lenders were unable to pull through the subprime crisis of 1998\textsuperscript{1737} and he enthusiastically revealed that the lender’s message in 2002 would be “The Quest for Stockholder Value.”\textsuperscript{1738} Despite early warning signs that the booming economy was potentially headed for trouble, Cole optimistically stated that an economic downtown would simply create “new and more customers” each passing day for “New Century’s

\textsuperscript{1736} Ibid.
\textsuperscript{1737} Ibid., “New Century in Black Again, On Sunny Side with Street,” \textit{The American Banker} (March 5, 2002).
subprime products.”1739 In anticipation of higher, subprime-generated profits, New Century began hiring additional salespeople and expanding its operations.1740

In the early 2000’s, New Century discovered that its sweet spot was originating mortgage loans with borrower FICO scores ranging from 500 to 680 and the lender began to grow at a rapid pace.1741 Compared to 1995, when New Century had 300 employees and originated $350 million worth of subprime mortgage loans, the lender had approximately 3,700 employees and originated $27 billion worth of subprime mortgage loans by the end of 2003. Three years later, at the end of 2006, New Century had more than 5,000 employees and originated more than $50 billion in subprime mortgage loans that year.1742

New Century’s spectacular growth during this time was accompanied by an equally impressive year-over-year profit performance. Whereas the lender made $48 million in 2001, its profits jumped 274% to $179.7 million in 2002.1743 Then, in 2003, New Century posted annual profits of $245.5 million, an increase of 36%.1744 The next year, New Century’s profits ballooned to $375.6 million, an increase of nearly another 53%.1745 In 2005, New Century’s profits reached $411 million, an increase of almost

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1739 Ibid.
1740 Erick Bergquist, “No. 2 in Subprime, New Century Aims Even Higher.”
1741 Ibid.
another 10%.\textsuperscript{1746} Finally, over the course of the first nine months of 2006, New Century posted profits of $276 million.\textsuperscript{1747}

From a stockholder’s perspective, there was indeed value in investing in shares of New Century during this time. An investor that purchased New Century stock in June of 1997 and then sold his or her shares in December of 2004 would have been rewarded with a handsome return of approximately 560%.

In the midst of these returns, New Century used a new branding initiative in 2005, one in which it labeled itself as “a new shade of blue chip.”\textsuperscript{1749} One should consider part of the press release that unveiled this initiative:

‘Blue chip’ is synonymous with companies known as quality investments that deliver long-term value for stockholders and are entrenched leaders in their industries. In addition, ‘blue chip’ connotes strong performance and stability. Like traditional blue chip companies, New Century Financial has outperformed its competitors with consistent and strong financial performance. As a ‘New Shade of Blue Chip,” New Century will update the traditional view of a ‘blue chip’ company by emphasizing not only strong results, but also how those results are achieved.\textsuperscript{1750}

With an incredible five-year profit performance behind them, New Century stunned the global investment community on February 7, 2007 with an announcement that it had to restate its financial statements for the first three quarters of 2006.\textsuperscript{1751} Right after the announcement, New Century’s stock price dropped precipitously.\textsuperscript{1752} About one month

\begin{itemize}
\item \textsuperscript{1747} Ibid.
\item \textsuperscript{1749} James Surowiecki, “Subprime Homesick Blues,” \textit{The New Yorker}, Vol. 83, No. 7 (April 9, 2007).
\item \textsuperscript{1750} Michael J. Missal, “Final Report for the District of Delaware, United States Bankruptcy Court: New Century TRS Holdings,” 49-50. Italics mine.
\item \textsuperscript{1751} Michael J. Missal and Lisa M. Richman, “New Century Financial: Lessons Learned.”
\item \textsuperscript{1752} Ibid.
\end{itemize}
later, on March 2, 2007, New Century admitted that they would be unable to issue its 2006 Annual Report on time, an announcement that incited investment and commercial banks to cease lending the distressed company any more money to originate subprime loans.\textsuperscript{1753} Six days later, on March 8, 2007, New Century stopped accepting loan applications from subprime borrowers.\textsuperscript{1754} Shortly after that fact became evident, the New York Stock Exchange delisted New Century’s securities.\textsuperscript{1755} On April 7, 2007, New Century filed for bankruptcy protection.\textsuperscript{1756}

3.21. Why Did New Century Financial Fail?

In June of 2007, The United States Bankruptcy Court for the State of Delaware “issued an order granting the U.S. trustee's motion for authorization to appoint an examiner in the New Century bankruptcy proceeding.”\textsuperscript{1757} The trustee appointed Michael Missal to conduct the investigation of New Century, which ending up taking nine months to complete. During the investigation, Missal reviewed thousands of New Century documents and conducted 110 interviews with 85 witnesses. His efforts culminated in the publication of an illuminating 551 page report that was publicly released on March 26, 2008. Missal’s report is perhaps the single most thorough examination of a subprime lender that is available to the public. It would be helpful to explore some of Missal’s major findings.

First, Missal affirmed that New Century “had a brazen obsession with increasing loan originations, without due regard to the risks associated with that business
strategy.” Missal also noted that “New Century measured loan quality primarily in terms of whether it was successful in selling loans to investors,” not in terms of whether the loans could be repaid by borrowers. In fact, employees in New Century’s loan production department were exclusively compensated by the volume of the loans that they originated.

Missal additionally disclosed that New Century originated the majority of their subprime loans by using mortgage brokers, who, in turn, were trained in a program that the lender called “CloseMore University.” New Century eventually formed relationships with over 50,000 mortgage brokers and the lender was able to fund more than $200 million worth of loans every business day in most months from April 2005 through December 2006. It is doubtful that individual state regulators could ever provide effective oversight of a subprime lender that had a scale of operations as vast as New Century.

Missal also discovered that over 70% of New Century’s originated loans had low initial teaser rates and over 40% of all of their originated loans were of the NINA variety. Moreover, he learned that the lender “made frequent exceptions to its underwriting guidelines for borrowers who might not otherwise qualify for a particular loan.” One particular type of exception that New Century would occasionally make for its borrowers was called “the pride of ownership” exception, which would raise

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1759 Ibid., 114.
1762 Ibid., 116.
1763 Ibid., 3.
1764 Ibid.
borrowers’ credit limits by as much as 15% depending upon how well they “maintained their homes relative to their neighbors.”

Finally, Missal determined that one of the key reasons why New Century failed was that its senior management “did not set an appropriate tone ‘at the top.’” Among their many shortcomings, Missal found that they “did not invest in the necessary technologies, systems, or personnel to meet its growing business and expanding challenges.” Missal further stated that New Century’s management team “turned a blind eye to the increasing risks” of their subprime originations and “did not take appropriate steps to manage those risks.” Even though there was an obvious emergence of “troubling loan quality trends” as early as 2004, Missal discovered that “no member of Senior Management was directed to be responsible and accountable for improving loan quality.”

In his effort to formulate reasons why the senior management team at New Century failed to make the quality of their loan originations a top priority, Missal concluded that “certain comparative data” suggested that their loans on average “were performing better than those of its competitors.” Also, Missal contended that “Senior Management appeared to believe that regardless of day-to-day market conditions… New Century would survive, just as it had survived the downturn of 1998-2001.” A former appraiser at New Century, Maggie Hardiman, later asserted that she “was not surprised


\[1767\] Ibid.

\[1768\] Ibid., 4.

\[1769\] Ibid., 111.

\[1770\] Ibid., 114.

\[1771\] Ibid.
by the company’s downfall” because few people “seemed to be thinking long-term.”

Instead, the predominant message that she heard from her superiors was to “approve more loans.” According to Hardiman, “[N]o one, from the top levels down to the lower levels of the office, didn’t want those [subprime] loans to go through.”

Although a considerable number of consumer complaints about New Century’s lending practices were filed with both the FTC and individual state agencies before the subprime mortgage crisis exploded, regulatory oversight of this non-depository independent lender was entirely inadequate. For instance, on January 31, 2007, a little over two months before New Century filed for bankruptcy protection, representatives from the company firmly opposed “the adoption of responsible underwriting standards for their lending activities” during a hearing before the California Senate Banking Committee. It is worth noting that the lender had a heavy subprime lending presence in California, with its headquarters stationed in the city of Irvine. New Century’s 2005 Annual Report indicated that 37% of its business that year was conducted in California.

Nevertheless, the New Century representatives testified in front of the California Senate Banking Committee that their adjustable-rate mortgages “needed no additional regulations or scrutiny.” In response to the proposal that the subprime guidance that was adopted by the Fed, OCC, and OTS in September of 2006 be applied to non-
depository independent mortgage lenders in the state of California, the New Century representatives stated, “The history and features of hybrid ARMs do not warrant inclusion in the guidance and to do so would cause severe, negative consequences for consumers, the real estate market and the economy.”\textsuperscript{1779} As New Century was preparing to file for bankruptcy, the Director of the California office of the Center for Responsible Lending observed, “Unfortunately, it now appears that these negative consequences are mounting from the failure to have just those kinds of standards in place.”\textsuperscript{1780} It is a testament to the power and complexity of large non-depository independent mortgage lenders like New Century that comprehensive subprime lending guidance was not in place, even as late as 2007, in a state that was a hotbed for those types of loans.

3.22. Conclusion

The elaborate and fragmented banking regulation system in the United States, leading up the subprime mortgage crisis, was not structured in a way that could bring about timely and effective oversight of many of the nation’s largest subprime mortgage lenders. The OCC and OTS’ federal preemption of state lending laws gave rise to a regulatory “race to the bottom” in the sense that their oversight synchronously became both more accommodating and wider in scope. The OTS and OCC generally failed to ensure the safety and soundness of many of the largest subprime lenders that they supervised, including Bank of America, N.A., JPMorgan Chase, N.A., Citibank, N.A., Wachovia Bank, N.A., and Wells Fargo Bank, N.A., WMC Mortgage Corporation, Option One Mortgage Corporation, First Franklin Financial, Washington Mutual, and

\textsuperscript{1779} Ibid.
\textsuperscript{1780} Ibid.
GMAC. The two federal regulators also never adequately addressed the consumer protection void created by their opportunistic preemption of state lending laws. In response to this sweeping federal preemption, Congressman Barney Frank maintained that the federal regulators had “bitten off fifty heads,” but did not “have the brainpower… to replace them.” Their federal preemption, furthermore, encouraged 46 state regulators to develop parity laws that defanged their own consumer protection laws.

The Fed, for its part, was unwilling to supervise non-depository mortgage lending affiliates that belonged to a holding company, most notably large subprime lenders like Countrywide, HSBC Finance, and CitiFinancial. In addition, the Fed obstinately refused to activate the UDAP component of the Home Ownership and Equity Protection Act of 1994, electing instead to require lenders to disclose information about the particular risks and features of their subprime loans to borrowers. Even though the Fed was “keenly aware that disclosures and financial education” were not always “sufficient to combat abusive practices,” it nevertheless was reluctant to actually prohibit particular unfair or deceptive lending practices by way of issuing rules. Reasons for this reluctance include their belief that whether a given lending practice “is unfair or deceptive depends heavily on the facts and circumstances” of individual cases, as well as their concern that prohibiting certain lending practices would “limit consumers’ options” in shopping for subprime mortgages.

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1781 The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps, 205.
1783 The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps, 205.
1785 Ibid.
1786 Ibid.
Finally, in general, state regulators were unable to provide effective oversight of enormous non-depository independent subprime mortgage lenders like Ameriquest and New Century. The sheer size and complexity of these lenders, along with their proclivity for allocating large sums of money for campaign contributions and lobbying expenditures,\textsuperscript{1787} made this breed of subprime lender especially difficult to regulate by individual states. Although each state had predatory lending laws of varying strength\textsuperscript{1788} as well as UDAP laws at their disposal to combat the origination of risky subprime loans by non-depository independent lenders in their state lines, I would argue that the pervasive failure of those lenders suggests that they were too large to be sufficiently supervised by fifty different state banking regulators.

\textsuperscript{1787} For example, from 1994 to 2008, Ameriquest made nearly $4 million in campaign contributions and reported over $1 million in lobbying expenditures. New Century, during the same period of time, made over $900,000 in campaign contributions and reported over $1.9 million in lobbying expenditures. Please see: The Center for Public Integrity, \textit{Who's Behind the Financial Meltdown: The Top 25 Subprime Lenders and Their Wall Street Backers}, 53-55.

Chapter Four

4.0. The Arrangers

4.1. Introduction

In March of 2010, former chairman of the Federal Reserve Board of Governors, Alan Greenspan, argued that “the global proliferation of securitized, toxic U.S. subprime mortgages” was the “immediate trigger” of the financial crisis. In chapter six, I will examine the role that two of the largest arrangers and issuers of securitized subprime mortgages played in creating conditions for the emergence of the subprime mortgage crisis: Fannie Mae and Freddie Mac. Presently, I will provide a sketch of how arrangers and issuers of non-GSE, or private label, subprime securities contributed to the subprime mortgage crisis. I will refer to arrangers and issuers of non-agency subprime securities as simply “arrangers.” Due to the complexity of the securitization process, my use of the term “arranger” will broadly include “[any] party that puts together securitization deals.”

Leading up to the outbreak of the subprime mortgage crisis, the five largest arrangers were the prominent, independent investment banks on Wall Street: Goldman Sachs, Morgan Stanley, Bear Stearns, Lehman Brothers, and Merrill Lynch. At the end of 2007, these five arrangers had a combined $280 billion in revenue and $30 billion in

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profits. By the end of 2008, due to the havoc caused by the subprime mortgage crisis, all five of those arrangers were no longer independent investment banks. Bear Stearns was acquired by JPMorgan in March of 2008, Merrill Lynch was acquired by Bank of America in September of 2008, Lehman Brothers filed for bankruptcy protection in September of 2008, and Morgan Stanley and Goldman Sachs became bank holding companies in September of 2008. As acknowledged in a sober September 22, 2008 article in The Wall Street Journal, those steps effectively marked “the end of Wall Street as it’s been known for decades.”

In July of 2011, The United States Government Accountability Office (GAO) issued a report that examined “the emergency actions taken by the Federal Reserve Board from December 1, 2007 through July 21, 2010.” The Dodd-Frank Wall Street Reform and Consumer Protection Act permitted GAO to conduct “a one-time audit” of the Fed’s actions during that time period. Astonishingly, the report revealed that the Fed made $16.1 trillion worth of loans to financial institutions over that period of time. Among the largest recipients of these loans were the five arrangers that will be explored in this section. The Fed’s loans during that period included $2.041 trillion to Morgan Stanley, $1.949 trillion to Merrill Lynch, $853 billion to Bear Stearns, $814 billion to Goldman Sachs, and $183 billion to Lehman Brothers. In light of the audit, Senator Bernie

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1794 Ibid.
1795 Ibid., 131.
1796 Ibid.
Sanders affirmed, “This is a clear case of socialism for the rich and rugged, you’re-on-your-own individualism for everyone else.”

I will begin this chapter with a brief discussion of how at least part of the subprime mortgage crisis was instigated by a supply-side phenomenon: arrangers aggressively attempting to attain exorbitant amounts of subprime loans for the sake of securitizing and selling them to investors. I will supplement this discussion with an exploration of the collapse of Lehman Brothers. Then, I will explore the various roles that arrangers played in an effort to show how they served as a conduit for subprime-related investments. Equally important, I will show how arrangers had “their tentacles in almost every corner” of the subprime mortgage market leading up to the crisis.

Next, I will define the term “collateralized debt obligations (CDOs),” which is a financial instrument that was a crucial part of the subprime mortgage crisis. Merrill Lynch’s collapse in 2008, for example, was abetted by their deep involvement with that troubled product. An understanding of three other terms is vital to this discussion of the subprime crisis: the alternative net capital rule, leverage, and repurchase agreements or “repos.” The importance of these terms will be accentuated by a brief account of the collapse of Bear Stearns.

I will then explain how credit-default swaps (CDSs) were a part of the subprime mortgage crisis, inasmuch as arrangers were attracted to them and they formed a doomed link between arrangers and the insurance company, AIG. I will argue that this link was

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characterized by the latter selling irresponsible amounts of CDSs to the former. Finally, I will conclude this section by examining how the two most prestigious arrangers, Goldman Sachs and Morgan Stanley, participated in and contributed to the subprime mortgage crisis.

4.2. The Supply-Side Angle of the Subprime Mortgage Crisis

Depository and non-depository lenders originated hundreds of billions of dollars worth of subprime loans leading up to the eruption of the subprime mortgage crisis. As Patricia McCoy and Kathleen Engel observe, “[i]f lenders had kept their subprime loans on their books, they probably would have made fewer loans and taken greater care with the ones they made.” However, because many of the largest subprime lenders participated in an originate-to-distribute model of lending, one in which they sold their mortgages to third parties, those lenders had a compelling incentive to focus primarily on the number of loans that they originated, rather than on the quality of those loans. A few words of elaboration are needed here.

One of the most fascinating aspects of the subprime mortgage crisis is that it was instigated, at least in part, by a supply-side phenomenon. By 2003, there was already evidence that subprime lenders were running out of eligible borrowers to which to extend mortgage credit. Large financial firms on Wall Street, the arrangers, nevertheless had a fierce appetite for subprime mortgages because there was a persistent “clamoring of

1799 The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps, 43.
1801 The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps, 207.
1802 Ibid., 33.
investors for high-yield mortgage-backed securities.” In an important sense, subprime lenders created or refined exotic mortgage products, such as NINA loans and Option ARMs, in response to an ever-increasing arranger demand for risky mortgage loans. Arrangers needed a constant influx of subprime loans from lenders in order to meet investor demand for products that could generate attractive returns. Subprime lenders, for their part, could originate risky mortgages, extract healthy commissions and fees from borrowers, and then sell the loans to eager arrangers. The incoming flow of money from arrangers refreshed the pool of funds that a lender could use to originate additional loans, enabling the latter to repeat the cycle of acquiring more commissions and fees from subprime borrowers.

Subsequently, the impetus for the irresponsible lending practices of many of the largest subprime lenders was the supply-side demand for subprime mortgages from arrangers. In this sense, subprime lenders became “too willing” to extend mortgage credit to borrowers because they were frequently making money “up front” rather than having to wait for the borrowers to repay the balance of their loans over time. Frank Partnoy inimitably summarized this phenomenon in this way:

The driving force behind the explosion of subprime mortgage lending in the U.S. was neither lenders nor borrowers. It was the arrangers… They were the ones supplying the cocaine. The lenders and borrowers were just mice pushing the button.

A vivid example that supports Partnoy’s claim can be found in a piece in The New York Times that was written on May 8, 2007. In this article, William Dallas, the founder and

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1803 Ibid.  
1804 Ibid., 45.  
former CEO of Ownit Mortgage Solutions, a failed subprime lender, accused the arranger Merrill Lynch of putting pressure on his firm to loosen its underwriting standards and originate more NINA loans. According to Dallas, the message that he received from Merrill Lynch about his reluctance to originate more NINA loans was: “You are leaving money on the table – do more of them.”1807 Although Dallas stated that he initially disagreed with Merrill Lynch’s injunction, eventually he acquiesced to their demands on the grounds that he could sell the risky loans at a profit.1808 In an effort to explore and expand upon this important point, I will now examine the extraordinary collapse of Lehman Brothers.

4.3. The Fall of Lehman Brothers

Lehman Brothers Holdings, Inc., originally founded by three brothers in 1850 as a cotton brokerage in Montgomery, Alabama,1809 was the first investment bank to embrace all aspects of the mortgage business, from origination to servicing.1810 Lehman Brothers’ history in the subprime sector stretches back to 1995, when the investment bank sent one of its vice presidents, Eric Hibbert, to California to inspect First Alliance Mortgage Company, a subprime lender.1811 After his visit, Hibbert wrote a memo that described First Alliance as a financial “sweat shop” that specialized in “high pressure sales for people who are in a weak state,” and whose employees leave their “ethics at the

1808 Ibid.
1810 David Faber, And Then the Roof Caved In: How Wall Street's Greed and Stupidity Brought Capitalism to Its Knees (Hoboken: Wiley, 2009), 73.
door.” Hibbert additionally observed that although First Alliance was clearly making loans to borrowers that have “no capacity for repayment,” there was “little risk for fraud or impropriety” at the lender. It is worth mentioning that First Alliance was already notorious for its predatory practices in 1995, reputed for “targeting elderly people and other vulnerable borrowers for extremely costly loans.” Nevertheless, Lehman Brothers determined that First Alliance was not breaking any laws, so they proceeded to open up a $500 million warehouse line of credit to the subprime lender, which ultimately financed the issuance of $700 million worth of mortgage-backed securities (MBSs) backed by First Alliance loans.

Two years later, in 1997, Lehman Brothers bought a stake in Aurora Loan Services, a lender and servicer that specialized in Alt-A loans. Soon after, in 1999,

1812 Ibid.
1813 Ibid.
1815 Michael Hudson, “Debt Bomb - Lending a Hand: How Wall Street Stoked The Mortgage Meltdown - Lehman and Others Transformed the Market For Riskiest Borrowers.” When an arranger extends a warehouse line of credit to a lender, the former typically gives the latter funds on a day-to-day basis for the sake of originating a desired amount and type of mortgage loans. Lenders draw on that line of credit until the arranger has determined that the number and quality of loans are sufficient for being securitized. This is a significant point because arrangers that offer warehouse lines of credit to lenders most likely have a better conception of those lenders’ daily operations – and the quality of their loans – than those arrangers that merely buy loans in bulk and securitize them. As one anonymous source said about Lehman Brothers’ warehouse lines of credit to lenders, “The argument would go that Lehman, as warehouse lender, would have reason to have a much greater level of knowledge about what the substance of those loans was actually like… You're giving [lenders] money basically to go out and buy assets, as opposed to merely packaging them as an agent, and selling them as bonds on the Street.” Indeed, when a San Francisco-based law firm, Jenkins & Mulligan, filed a lawsuit against First Alliance in 2000 for its predatory lending practices, Lehman Brothers was listed as a co-defendant, in part because it extended a $150 million warehouse line of credit to the lender. As a result of this relationship, Lehman Brothers was accused of “having knowledge of First Alliance's fraudulent practices, and thereby tacitly or expressly approving those practices in its financing of the lending operations.” Please see: Michael Gregory, “Lehman to Take Fall for Predatory Lender,” Asset Sales Report (May 8, 2000); Ibid., “The Predatory Lending Fracas: Wall Street Comes Under Scrutiny in the Subprime Market as Liquidity Suffers and Regulation Looms,” Investment Dealers Digest (June 26, 2000).
1816 Mark T. Williams, Uncontrolled Risk: The Lessons of Lehman Brothers and How Systemic Risk Can Still Bring Down the World Financial System (New York: McGraw Hill, 2010), 129. As late as October 17, 2007, Lehman Brothers considered Alt-A loans suitable products for borrowers who had a minimum FICO score of 640 and “a greater need for flexibility specific to documentation types, asset verification, equity

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Lehman Brothers started operating its own subprime lending unit, Finance America, which was part of a joint venture with the struggling subprime lender, Amresco Corporation. Lehman Brothers agreed to extend a warehouse line of credit to Amresco in order to originate, purchase, and securitize subprime home equity loans.\footnote{Shane Kite, “Amresco Wins Friend, Looks for Buyer,” Asset Sales Report (July 26, 1999).}

During this time, allegations surfaced that First Alliance loan officers were using deceptive sales practices in order to steer borrowers into harmful loans that had excessively high fees. Seven states, along with a group of federal regulators, began investigating the subprime lender’s operations. Tellingly, a 1999 memo revealed that Lehman Brothers was both aware of the government probes and concerned that its relationship with First Alliance could potentially damage its reputation. However, the memo recommended that Lehman Brothers continue its funding of First Alliance loans because their “borrowers rarely defaulted on their loans and… Lehman stood to earn millions in fees by managing the lender’s mortgage-backed securities deals.”\footnote{Michael Hudson, “Debt Bomb - Lending a Hand: How Wall Street Stoked The Mortgage Meltdown - Lehman and Others Transformed the Market For Riskiest Borrowers.”} First Alliance eventually collapsed in March of 2000 under the weight of increasingly formidable lawsuits and investigations.\footnote{Ibid.}

Undeterred from its commitment to financing and securitizing subprime loans, Lehman Brothers purchased a small ownership stake in another subprime lender in 2000, BNC Mortgage Corporation.\footnote{Mark T. Williams, Uncontrolled Risk: The Lessons of Lehman Brothers and How Systemic Risk Can Still Bring Down the World Financial System, 129.} By the end of that year, Lehman Brothers issued $8.942
billion worth of subprime MBSs, second to only Bear Stearns among all arrangers.\textsuperscript{1821} Lehman Brothers, churning out loans through BNC Mortgage and Aurora Loan Servicing, ended up securitizing $10.702 billion, $10.213 billion, and $8.774 billion worth of subprime MBSs in 2001, 2002, and 2003, respectively.\textsuperscript{1822}

One should note that, in 2003, after nearly a four-year legal battle, a federal jury in California fined First Alliance for $50.1 million for fraud. The jury ruled that Lehman Brothers “substantially assisted” First Alliance in its fraudulent activities and fined the arranger $5.1 million.\textsuperscript{1823} That same year, Lehman Brothers also settled a lawsuit in Florida, one in which it was accused for being “an accomplice” to First Alliance. The arranger settled for $400,000 without admitting any wrongdoing.\textsuperscript{1824}

As Kevin Connor convincingly argues, these paltry settlements sent a momentous and resounding message to the other large arrangers on Wall Street: those firms that securitize risky loans of questionable integrity will, at best, be held \textit{minimally liable} for funding subprime lenders. In other words, the settlements gave at least a temporary answer to the pointed question that HUD Secretary Andrew Cuomo raised at a hearing in May of 2000: “What is [an arranger’s] affirmative obligation to go deeper than just the surface? What is their affirmative obligation to know what mortgage they’re securitizing and to know what type of business they’re actually financing?”\textsuperscript{1825} In light of the meager

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\textsuperscript{1821} Compass Point Research & Trading LLC, \textit{Mortgage Finance: Mortgage Repurchases Part II: Private Label RMBS Investors Take Aim – Quantifying the Risks} (August 17, 2010), 8. The authors do not define the term “subprime” in their report.
\textsuperscript{1822} Ibid.
\textsuperscript{1823} Gretchen Morgenson, “A Shadow of Liability Over Wall St.,” \textit{The International Herald Tribune} (July 13, 2009).
\textsuperscript{1824} Michael Hudson, “Debt Bomb - Lending a Hand: How Wall Street Stoked The Mortgage Meltdown - Lehman and Others Transformed the Market For Riskiest Borrowers.”
\textsuperscript{1825} Michael Gregory, “The Predatory Lending Fracas: Wall Street Comes Under Scrutiny in the Subprime Market as Liquidity Suffers and Regulation Looms.”
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fines levied against Lehman Brothers in 2003, the previously uncertain obligations of
arrangers that Cuomo underscored could now be perceived as loose or negligible.

Supporting his case that the settlements emboldened other Wall Street arrangers
to expand their subprime securitization operations, Connor provocatively notes that the
total value of all subprime securitizations jumped from $202 billion in 2003 to $401
billion in 2004, an increase of nearly 100%, which was the single largest year-over-year
surge in the history of subprime mortgage securitization.\(^{1826}\) The astronomical increase of
Goldman Sachs’ subprime MBS securitizations from 2003 to 2004 is a case in point. In
2003, Goldman Sachs securitized $2.538 billion worth of subprime MBSs, a figure that
jumped to $9.506 billion in 2004, an astounding 274% increase.\(^{1827}\)

By the end of 2003, Lehman Brothers gained complete ownership of Aurora Loan
Servicing and then, in 2004, the arranger purchased BNC Mortgage in its entirety.\(^{1828}\)
Both companies came to be part of Lehman Brothers’ Mortgage Capital Division.\(^{1829}\)
Over the course of 2004 and 2005, Lehman Brothers, aided by its subprime subsidiaries,
securitized approximately $27.083 billion worth of subprime MBSs.\(^{1830}\) However,
competitive pressures from other large arrangers like Countrywide ($82.790 billion worth
of subprime securitizations in 2004 and 2005 combined), Bear Stearns ($25.949 billion
worth of subprime securitizations in 2004 and 2005 combined), and Goldman Sachs

\(^{1827}\) Compass Point Research & Trading LLC, Mortgage Finance: Mortgage Repurchases Part II: Private
Label RMBS Investors Take Aim – Quantifying the Risks, 8.
\(^{1828}\) Mark T. Williams, Uncontrolled Risk: The Lessons of Lehman Brothers and How Systemic Risk Can
\(^{1829}\) Anton R. Valukas, “Southern District of New York, United States Bankruptcy Court: Lehman Brothers
Holdings, Inc., et al, Volume 1,”(March 11, 2010), available at
\(^{1830}\) Compass Point Research & Trading LLC, Mortgage Finance: Mortgage Repurchases Part II: Private
Label RMBS Investors Take Aim – Quantifying the Risks, 8.
($20.813 billion worth of subprime securitizations in 2004 and 2005 combined)\textsuperscript{1831} contributed to Lehman Brothers’ decision to make a significant change in its business strategy in 2006.\textsuperscript{1832} Anton R. Valukas’ magisterial nine-volume, 2,200 page report on the bankruptcy of Lehman Brothers describes this shift in business strategy in detail. The U.S. Bankruptcy Court in Manhattan appointed Valukas to conduct the investigation of Lehman Brothers’ collapse in January of 2009.\textsuperscript{1833} Approximately fourteen months later, in March of 2010, the report was released.

According to Valukas’ report, Lehman Brothers historically considered itself to be “primarily in the moving business, not the storage business.”\textsuperscript{1834} As the report explains, this meant that, traditionally, one of Lehman Brothers’ strengths was securitizing residential mortgages and moving them to third party investors.\textsuperscript{1835} In 2006, however, Lehman Brothers’ management “decided to emphasize the storage business,” which entailed acquiring real estate assets, including subprime MBSs, and holding on to them, treating them as long-term investments.\textsuperscript{1836} The Lehman Brothers management team determined that that these investments “were highly profitable relative to their risk” in the booming economic environment, and that they were “missing out on significant opportunities” that other arrangers were already exploiting.\textsuperscript{1837}

In the late part of 2006, the subprime mortgage market began to show signs of weakness as housing prices began to decline and increasingly more subprime loans

\textsuperscript{1831} Ibid.
\textsuperscript{1833} Christopher Scinta, “Valukas Named to Investigate Lehman Creditor’s Claims,” Bloomberg News (January 20, 2009).
\textsuperscript{1835} Ibid.
\textsuperscript{1836} Ibid.
\textsuperscript{1837} Ibid., 59-60.
became delinquent. As the report makes clear, Lehman Brothers’ management team was aware of this downturn. The arranger discovered that investors were becoming progressively risk-averse, making it difficult to find clients who were interested in its subprime MBSs. Due to these troubling trends, Lehman Brothers decided to tighten BNC’s subprime origination standards. Nevertheless, according to data provided by *Inside Mortgage Finance*, Lehman Brothers was responsible for generating $52 billion worth of subprime securitizations in 2006.

Paradoxically, over this same period of time, Lehman Brothers decided to increase its Alt-A originations through Aurora Loan Servicing. While these loans were not as risky as BNC’s subprime loans, Lehman Brothers’ risk managers considered them to be riskier than their Alt-A designation suggested, occasionally dubbing them “Alt-B loans.” In late January 2007, a Lehman Brothers’ mortgage analyst, after examining Aurora’s loan originations over the previous four months, noticed that those loans were the lender’s “riskiest loans ever, with every month being riskier than the one before.” Valukas’ report reveals that Aurora’s Alt-A loans “came more and more to resemble the subprime loans that Lehman was supposedly exiting by tightening origination standards at BNC.” Despite these warnings, Lehman Brothers’ stock price

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1838 Ibid., 78.
1839 Ibid., 84.
1840 Ibid., 85.
1843 Ibid. 88.
1844 Ibid.
1845 Ibid., 87.
reached an all-time high of $86.18 per share in February of 2007.\textsuperscript{1846}

By the spring of 2007, the subprime crisis had advanced to the point that twenty of the major subprime lenders had either gone bankrupt or had been acquired by stronger partners.\textsuperscript{1847} Crucially, Lehman Brothers’ management “saw the subprime crisis as an opportunity to pick up ground on its competitors,” so they elected to adopt a “countercyclical growth strategy.”\textsuperscript{1848} The strategy was unveiled on March 20, 2007, when Lehman Brothers’ Mortgage Capital and Fixed Income Divisions gave a presentation to the arranger’s board of directors. According to Valukas’ report, Lana Franks Harber, Chief Administrative Officer of the Mortgage Capital Division, e-mailed one of her colleagues prior to the presentation, explaining that she had spoke with Joseph Gregory, Lehman Brothers’ President, about the meeting. In the e-mail, she states:

[The] Board is not sophisticated around subprime market – Joe doesn’t want too much detail. He wants to candidly talk about the risks to Lehman but be optimistic and constructive – talk about the opportunities that this market creates and how we are uniquely positioned to take advantage of them.\textsuperscript{1849}

Consistent with Harber’s advice, the presentation emphasized that the recent downturn in the subprime mortgage market presented “substantial opportunities” to Lehman Brothers, noting that if they kept a strong presence in the market, they would be “better positioned for profitable growth once the industry cycle turned.”\textsuperscript{1850} This optimism was anchored by several key assumptions, such as the belief that a “substantial part of [the] subprime market is here to stay” and that “[p]rofitability will return when [the] environment

\textsuperscript{1848} Ibid., 79-80.
\textsuperscript{1849} Ibid., 90-91.
\textsuperscript{1850} Ibid., 92.
improves.”

Strikingly, the presentation did not discuss Aurora’s alarming Alt-A originations at all, but instead lumped the loans into a category listed as “Prime/Alt-A Mortgages.” One slide maintained that the loans’ “credit performance [was] not problematic.” Valukas’ report notes that the loans were labeled “Alt-A/Alt-B Mortgages” in an earlier draft of the presentation and were similarly presented as having an unproblematic credit performance.

In August of 2007, when both Countrywide and Ameriquest failed, Lehman Brothers decided to immediately cease BNC’s subprime lending operations. However, the arranger continued to originate risky Alt-A/Alt-B loans through Aurora all the way up until January of 2008. As Valukas’ report explains, once the subprime mortgage market progressively deteriorated in 2008, Lehman Brothers discovered that it had accumulated mortgage assets that it could no longer sell, except at a loss. These illiquid mortgage assets, Valukas’ report concludes, “played a significant role in Lehman’s ultimate financial failure.”

During the second quarter of 2008, in the wake of the collapse of Bear Stearns, Lehman Brothers frantically sold about $16 billion worth, or about one-fifth, of its mortgage assets. The arranger suffered huge losses on those sales and ended up

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1851 Ibid.
1852 Ibid.
1853 Ibid.
1854 Ibid.
1855 Ibid., 86.
1856 Ibid., 138.
1857 Ibid., 46.
1858 One should note that these toxic assets were not limited to subprime and Alt-A/Alt-B mortgages. Valukas’ report meticulously documents how commercial real estate assets heavily contributed to Lehman Brothers’ downfall as well. Please see: Anton R. Valukas, “Southern District of New York, United States Bankruptcy Court: Lehman Brothers Holdings, Inc., et al,” 103-113; 172-175.
1859 Ibid., 45.
announcing a quarterly loss of $2.8 billion on June 9, 2008.\textsuperscript{1860} By the end of July of 2008, Lehman Brothers’ stock price had fallen to around $18 per share,\textsuperscript{1861} a decrease of nearly 80\%. By mid-August of that year, Lehman Brothers’ stock price had plummeted to less than $14 a share.\textsuperscript{1862} According to Mark T. Williams, in his book \textit{Uncontrolled Risk}, the fate of Lehman Brothers at this point in time hinged upon the Korea Development Bank (KDB) purchasing the firm.\textsuperscript{1863}

On Tuesday September 9, 2008, KDB announced that it would not purchase Lehman Brothers for even $8 a share, contributing to another 45\% decrease in the arranger’s stock price.\textsuperscript{1864} The following day, Lehman Brothers’ CFO Ian Lowitt disclosed that the arranger had lost a total of $3.9 billion over the course of the third quarter, stemming largely from $5.6 billion in real estate-related losses.\textsuperscript{1865} JPMorgan revealed on Thursday September 11 that it had now cut off its credit to the distressed arranger. Lehman Brothers’ stock price fell to $4.22 a share that day.\textsuperscript{1866}

After a tumultuous weekend of negotiations on September 13 and 14, it became evident that Lehman Brothers was not going to be rescued by the Fed or purchased by another firm. By Sunday afternoon, SEC Chairman Christopher Cox contacted Lehman Brothers’ Board of Directors and made the unprecedented recommendation that the arranger file for bankruptcy. The Board unanimously voted in support of Cox’s recommendation that same day. Early in the morning on Monday September 15, 2008,

\textsuperscript{1860} Yalman Onaran and John Helyar, “Fuld Sought Buffett Offer He Refused as Lehman Sank.”
\textsuperscript{1862} Ibid., 166.
\textsuperscript{1863} Ibid., 163.
\textsuperscript{1864} Ibid., 167-168.
\textsuperscript{1865} Ibid., 168.
Lowitt signed the bankruptcy documents and instantly “the largest bankruptcy in U.S. history was official.” Later that same morning, before the opening bell, a “158 year old company that had weathered many a storm” with over 25,000 employees had its LEH ticker quietly removed from the New York Stock Exchange.

4.4. The Multiple Roles of Arrangers in the Subprime Securitization Process

As the description of Lehman Brothers’ collapse reveals, arrangers were heavily involved in the subprime mortgage pipeline. Securitization revolutionized the way in which many residential mortgages came to be funded, which is a central reason why arrangers became part of the mortgage financing process. Securitization “unbundled” or “atomized” the mortgage loan process, supposedly enabling different parties to specialize in each part of the process. In particular, securitization linked investors that were interested in high-yield investment products to borrowers that were seeking to receive a mortgage-related loan. One of the parties that helped link investors to borrowers was the subprime lenders, a party that is examined in another section of this study. Another party that was a crucial part in bridging the gap between investors and borrowers was the arrangers. What roles did arrangers play in connecting investors to borrowers?

1868 Ibid.
1871 I use the term “mortgage-related” because borrowers could seek funding not only for the sake of purchasing a home, but also to refinance an existing mortgage loan, obtain a second mortgage, or even to tap into a home equity line of credit to make any number of purchases.
First, arrangers purchased subprime mortgage loans from lenders, or even purchased subprime lenders of their own.\textsuperscript{1872} One should note that a disturbing lack of transparency characterized the majority of the arranger/lender transactions. Typically, arrangers would strive to delineate clear boundaries between themselves and the lenders from which they purchased subprime loans.\textsuperscript{1873} These precautions were taken because arrangers did not want to be held legally responsible for any of the potential misdeeds that could have been performed as the lenders were in the act of originating the loans.\textsuperscript{1874}

Prior to the completion of the sale, arrangers would usually require lenders “to provide them with representations (reps) and warranties” about the quality of the loans and the characteristics of the borrowers who had received them.\textsuperscript{1875} Reps and warranties “included assurances that the loans complied with state and federal laws and satisfied [the lender’s] stated underwriting criteria.”\textsuperscript{1876} Most arranger/lender subprime mortgage purchase agreements included provisions that entitled arrangers to force lenders to

\textsuperscript{1872} The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps, 56. Five of the biggest arrangers, Lehman Brothers, Merrill Lynch, Goldman Sachs, Morgan Stanley, and Bear Stearns, purchased subprime lenders, which afforded them the opportunity to more efficiently streamline the subprime mortgage origination process into their own securitization operations. Please see: The Financial Crisis Inquiry Commission, The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States, (January 2011), available at http://fcic.law.stanford.edu/report, 88. According to Paul Muolo and Mathew Padilla, it was a “well-kept secret” that arrangers originated their own residential mortgages because of the potential for reputational damage. Please see: Paul Muolo and Mathew Padilla, Chain of Blame: How Wall Street Caused the Mortgage and Credit Crisis (Hoboken: John Wiley & Sons, 2008), 191. As Patricia McCoy and Kathleen Engel note, many arrangers “had vertically-integrated production factories” that included “lenders, servicers, and insurers.” Please see: The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps, 57. Consequently, one should note that arrangers could simultaneously serve as lenders, while large subprime lenders, such as Countrywide, could simultaneously serve as arrangers. This fact makes it difficult to neatly classify a given firm as simply “an arranger” or “a lender.”

\textsuperscript{1873} Kathleen C. Engel and Thomas J. Fitzpatrick IV, “False Security: How Securitization Failed to Protect Arrangers and Investors from Borrower Claims,” 9.

\textsuperscript{1874} Ibid.

\textsuperscript{1875} The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps, 45.

\textsuperscript{1876} Ibid.
repurchase misrepresented loans.\textsuperscript{1877} Indeed, as the subprime mortgage crisis intensified in severity, many subprime lenders were doomed by their repurchase agreements.\textsuperscript{1878} New Century Financial, for instance, was forced to repurchase over $5 billion worth of flawed subprime loans from arrangers in 2006 alone.\textsuperscript{1879}

In addition to reps and warranties, arrangers would hire due diligence firms to confirm that the loans met the lenders’ underwriting standards and procedures.\textsuperscript{1880} The due diligence firms were also commissioned to verify the accuracy of the information on borrowers’ applications and to ensure that all the loan documents were in order.\textsuperscript{1881} Remarkably, due diligence reviews were the only occasions that “individual loan files normally received outside scrutiny during the securitization process.”\textsuperscript{1882} When subprime mortgage lending reached its peak in 2006, the three largest due diligence firms were Clayton Holdings, Bohan Group, and Opus Capital.\textsuperscript{1883}

One would think that the rapid expansion of the subprime mortgage market in the early 2000’s, accompanied by the proliferation of novel and complex mortgage products during this time, would have been sufficient for inciting arrangers to pay due diligence firms larger sums of money in order to more thoroughly scrutinize lenders’ loan portfolios and borrowers’ loan applications. A striking 2008 article in \textit{The New York Times}, however, revealed that due diligence firms’ reviews of mortgage loans declined an


\textsuperscript{1878} Ibid.


\textsuperscript{1880} \textit{The Subprime Virus}: \textit{Reckless Credit, Regulatory Failure, and Next Steps}, 45.

\textsuperscript{1881} Ibid.

\textsuperscript{1882} Ibid.

\textsuperscript{1883} \textit{The Financial Crisis of Our Time}, 209.
average of over 80% from 1995 to 2005. Arrangers had to pay due diligence firms roughly $350 for each loan that they inspected, so commissioning the firms to review less loans saved the arrangers significant sums of money. The drastic reduction of due diligence reviews in the early 2000’s was likely fueled by the arrangers’ desire to cut costs.

One should also note that the effectiveness of due diligence reviews was undermined by the dramatic increase of low- and no-doc loan originations. Without paystubs or tax returns on hand to verify a given borrower’s stated income or employment history, due diligence firms could not assess that borrower’s actual ability to repay the loan and, hence, whether that borrower should have been approved for the loan in the first place. Irma Aninger, who performed due diligence reviews for both Clayton Holdings and the Bohan Group, stated, “You can’t tell me a Kmart or a Wal-Mart or a Target floor worker is making $5,000 a month, or a house cleaner is making $10,000… [but my supervisors] would say, ‘You can’t do that. You can’t call these people liars’.”

The concept of due diligence underwent a fundamental transformation leading up to the subprime mortgage crisis. Whereas due diligence reviews in the past tended to focus on the quality of loans, performing due diligence eventually morphed into an impoverished examination of whether a loan merely conformed to the arranger’s guidelines, even if those guidelines were vague, unreasonable, or permitted

1885 Ibid.
1886 Ibid.
1887 The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps, 46.
exceptions. The president Clayton Holdings, Keith Johnson, stated, “In some cases we felt that we were potted plants.” A former managing director for Bear Stearns observed, “Bear didn’t really care about quality. They wanted volume.” From the perspective of due diligence firms, their primary, if not exclusive, responsibility was to provide the arrangers with the kind of review that they requested. A chief executive of a due diligence firm looked back on this transformation and quipped, “Common sense was sacrificed on the altar of materialism.”

A July 2011 lawsuit filed against the arranger Morgan Stanley provided a memorable example of this phenomenon. According to the lawsuit, Morgan Stanley knew that lenders such as New Century “routinely flouted the law and disregarded basic underwriting standards.” One of the primary sources of this information was the due diligence firm that the arranger hired, Clayton Holdings. As the lawsuit reveals, Clayton Holdings would assign each of the loans that were part of its due diligence reviews a number. Assigning a “1” to a given loan indicated that it conformed to the lender’s underwriting standards, while assigning a “2” signified that the loan contained multiple exceptions to those standards. The worst rating was a “3”, which signaled that the loan did not comply with the lender’s underwriting standards at all.

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1889 The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps, 46.
1892 Ibid., 211.
1893 Vikas Bajaj and Jenny Anderson, “Inquiry Focuses on Withholding Data of Loans.”
1895 Ibid., 63.
It is noteworthy that Morgan Stanley was privy to that rating scale because the
arranger was supposed to only receive a “yes” or a “no” from Clayton Holdings regarding
the quality of a given loan. Instead, Morgan Stanley would routinely use the loans that
earned a rating of a “3” as leverage for negotiation with the various lenders. Rather
than reject the loans rated a “3” and refuse to purchase them for securitization, Morgan
Stanley habitually elected to use that information to insist that the defective loans receive
a better price.

As disclosed by the former vice-president of Morgan Stanley’s due diligence
department, Tony Peterson, the arranger unquestionably compromised the independence
and integrity of Clayton Holdings’ assessments. Peterson noted that his department would
determine which loans Clayton Holdings could sample and, as a matter of course, could
reject or even reassign the due diligence firm’s ratings of the loans. At one point,
Peterson confessed in an interview with the Financial Crisis Inquiry Commission:

During the diligence process, if Clayton elevated something as a 3,
regardless of the reason… our team would take a look at that and, at their
first review of the issues of the overall loan, they could make a decision
at that point that it was acceptable and change the grade to a 2W…. And
then when our process was complete, we sent the reports up to New York
indicating which loans were still a 3, which loans we had changed to a 2W.
And then that was the end of our diligence process.

Clayton Holdings found that, from 2006 to the middle part of 2007, over one-third of the
loans that the firm reviewed for Morgan Stanley earned the rating of a “3”, but ultimately

1896 Ibid., 64.
1897 Ibid.
1898 Ibid., 63-64.
1899 Ibid., 64. This interview is available at: http://fcic.law.stanford.edu/resource/interviews#P.
56% of those defective loans were waived by the arranger, securitized into MBSs, and then sold to investors.\textsuperscript{1900}

Paying for due diligence reviews, requiring lenders to supply them with reps and warranties, and purchasing lender-originated subprime mortgages were just three of the basic activities that arrangers could carry out in order to obtain the “raw materials” for creating subprime securitizations. Having obtained a pool of disparate subprime mortgages from lenders, arrangers would then proceed to sell the loans to a bankruptcy-remote trust known as a special-purpose vehicle (SPV).\textsuperscript{1901} SPVs are “essentially robot firms that have no employees, make no substantive economic decisions, have no physical location, and cannot go bankrupt.”\textsuperscript{1902}

Housing the loans in a SPV had the advantage of protecting both the arranger and lender from any losses that could arise from borrower delinquencies or defaults.\textsuperscript{1903} Moreover, this bankruptcy protection also increased the probability that the NRSRO’s would later provide higher ratings to the securities that were backed by the mortgages in a SPV.\textsuperscript{1904} Arrangers were enamored with triple-A ratings because once one of the “big three” NRSRO’s gave that rating to their securities, they typically did not need to pay the other two NRSRO’s to rate those same securities.\textsuperscript{1905} Arrangers tended to be ratings-
sensitive, showing little regard for which of the three largest NRSRO’s actually provided those ratings.

With the pools of mortgages couched in a SPV, arrangers would then divide “the principal and interest payments from borrowers into tranches” or slices. Each tranche “had its own bond, with its own yield, maturity date, and level of risk.” Some of these structured products had over twenty tranches. As Patricia McCoy and Kathleen Engel explain:

The top tranche was the safest, with the lowest interest rate, and was paid off first. The tranche right below the senior tranche was paid off next and had a slightly higher risk with a slightly higher interest rate. And so it went down the line to the last tranche, the junior tranche or equity tranche. The equity tranche was the last to be paid, offered the highest interest, and was the first to absorb losses if borrowers defaulted.

Similar to the rationale behind selling the pools of loans to a SPV, one of the main purposes of creating tranches was to ensure that at least one tranche would receive a high investment-grade rating from one of the three largest NRSRO’s. If a NRSRO ended up giving an investment-grade rating to a particular mortgage-backed security, it would legally permit large investors, like pension plans, insurance companies, and municipalities to invest in that security.

Once the loans were situated in a SPV, arrangers would hire a NRSRO to grade each tranche based on the credit risk that the product contained. Arrangers would send

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1906 *The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps*, 47.
1907 Ibid.
1908 Ibid.
1909 Ibid.
1911 Mortgage-backed securities are financial products that are backed by collateral consisting of the loans in an arranger’s purchased loan pool.
1912 *The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps*, 48.
1913 Ibid., 47.
their hired NRSRO information about the prospective mortgage-backed security as well as data about loans in the pool that were backing the security.\footnote{United States Senate Permanent Subcommittee on Investigations, \textit{Wall Street and the Financial Crisis: Anatomy of a Financial Collapse} (April 13, 2011), available at http://levin.senate.gov/newsroom/supporting/2011/PSI_WallStreetCrisis_041311.pdf, 250.} In a separate section of this study, I examined how the arranger-pays compensation structure put pressure on Standard and Poor’s, Fitch, and Moody’s to inflate their credit ratings. Furthermore, I also noted how the three NRSRO’s relied upon the arrangers to supply accurate information about the characteristics of the loans and borrowers. The three NRSRO’s emphatically stated that they were not responsible for conducting due diligence assessments of the accuracy of the underlying information upon which they were basing their credit ratings. Essentially, it was up to each arranger to ensure that critical pieces of loan-level information were accurate, including “borrowers’ credit scores, loan-to-value ratios, whether the borrowers documented their incomes, whether the properties were owner-occupied, and whether the loans were used to refinance an existing home or to buy a home.”\footnote{The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps, 47-48.} With subprime lending standards deteriorating at the level of loan origination, and the quality of due diligence reports diminishing at the level of the arrangers, one has to question the extent to which the three NRSRO’s could accurately assess the credit risk that any given mortgage-backed security contained, even if one operates under the generous assumption that they were utilizing flawless risk models.

Investors, for their part, were attracted to highly rated mortgage-backed securities for at least three reasons. First, the products were perceived to be well-diversified, typically backed by hundreds or even thousands of mortgage loans that were originated in
geographically distinct regions. Second, mortgage-backed securities buffeted investors with an array of investment choices that suited their individual tastes for risk, anticipated rate of return, and preferred duration. Finally, mortgage-backed securities, in many instances, featured yields that exceeded those offered by “conventional government and corporate bonds.” Large institutional investors, therefore, ended up taking “to subprime mortgage-backed securities like fish to water” because many of the securities were sufficiently diverse, customizable, and complemented by a compelling risk/reward ratio.

In the early 2000’s, arrangers responded to this investor-demand for subprime mortgage-backed securities by progressively issuing more of them. In 2001, arrangers issued $87 billion worth of subprime mortgage-backed securities. Just four years later, in 2005, arrangers issued $465 billion of those securities, an increase of over 434%. From 2004 to 2008, arrangers issued a breathtaking $2.5 trillion worth of mortgage-backed securities.

In addition to the roles mentioned above, arrangers could also serve as an underwriter or a placement agent for their issued mortgage-backed securities and collateralized debt obligations (CDOs). Generally, arrangers chose to serve as underwriters for their issued mortgage-backed securities, while opting to serve as

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1917 Ibid.
1918 Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps, 58.
1919 Ibid.
1922 I will discuss CDOs and greater detail below.
placement agents for their issued CDOs. As underwriters, arrangers would issue their mortgage-backed securities to the public, after registering the securities with the SEC. 

Arrangers would also be responsible for releasing registration statements or prospectuses that contained information about their operations and management, as well as “key financial data, and other important facts to investors.” On average, arrangers charged anywhere from $1 million to $8 million to act as the underwriter of a securitization involving mortgage-backed securities.

In the event that arrangers elected not to issue a new security to the public, which was frequently the case for their newly securitized CDOs, they could offer them to investors through a private placement. In this case, arrangers would act as a placement agent, which involved designing, marketing, and selling the CDO to particular, private investors. Typically, arrangers charged $5 million to $10 million to act as a placement agent of a CDO securitization. Regardless of whether arrangers served as underwriters or placement agents, they were potentially “liable for any material misrepresentations or omissions of material facts made in connection with a solicitation or sale of a security to an investor.”

Finally, arrangers could also serve as market makers or engage in proprietary trading. Instead of simply arranging for a public or private offering of a mortgage-backed security or CDO, arrangers could also assume the role of a market maker, which involved

1924 Ibid.
1925 Ibid.
1926 Ibid.
1927 Ibid.
1928 Ibid.
1929 Ibid.
1930 Ibid.
buying and selling financial products to their clients and other market participants. Arrangers would acquire an inventory of mortgage-backed securities and CDOs, slightly mark up the price of those securities, and then fill, buy, and sell orders for investors. Serving as market makers, arrangers contributed to making the market for mortgage-backed securities and CDOs more liquid.

As for the option of participating in proprietary trading, arrangers could, likewise, buy and sell mortgage-backed securities and CDOs. The key difference between engaging in proprietary trading and acting as a market maker is that in the former case, arrangers buy and sell securities for their own accounts, as opposed to filling buy and sell orders for clients and other market participants. It is worth noting that arrangers could simultaneously act as market makers and engage in proprietary trading, while often using “the same inventory of financial products” to carry out both tasks.

As a way of concluding this discussion on the multiple roles of arrangers, I will briefly examine how Goldman Sachs went about securitizing a particular pool of subprime loans. In the spring of 2006, Goldman Sachs bundled together 8,274 subprime mortgage loans that it had purchased from a variety of lenders, including Fremont Investment & Loan and Long Beach Mortgage Company. Goldman Sachs placed the loans into a trust known as GSAMP Trust 2006-S3. The loans in the trust possessed a total value of $494 million and had an average loan-to-value ratio of 99.29%, meaning that the borrowers who obtained the loans had an average equity in their homes of just 0.71%. A full 58% of the loans were either low- or no-documentation loans. Goldman

1931 Ibid.  
1932 Ibid.  
1933 Ibid.  
1934 Ibid.
Sachs proceeded to slice the pool into thirteen tranches and submitted them to two NRSRO’s, Moody’s and Standard and Poor’s, for a credit rating evaluation. Both of the NRSRO’s rated 68% of the tranches AAA (Aaa) and 25% of the tranches AA (Aa) to BBB (Bbb). Less than a year after the securities were issued, both Moody’s and Standard and Poor’s downgraded the triple-A rated securities to BBB (Bbb). A few months later, nearly one out of five loans in the pool had defaulted and investors in the six lowest rated tranches were completely wiped out. Nicholas Weill, Moody’s chief credit officer for their structured finance division, conceded that “in hindsight” the NRSRO “would not have rated” the tranches because they did not have enough information about the quality of the underlying loans.1935

4.5. A Thumbnail Sketch of Collateralized Debt Obligations (CDOs)

Despite the fact that arrangers issued an extraordinary amount of mortgage-backed securities shortly before the eruption of the subprime mortgage crisis, investors tended primarily to prefer only those tranches that were rated triple-A by one of the three largest NRSRO’s.1936 This trend became especially prevalent around 2003.1937 Arrangers began to realize that the other investment-grade tranches of their subprime securitizations, known as the mezzanine tranches, were difficult to sell, so they started to repackage the unwanted tranches into a type of security that was created in 1987 by

Michael Milken’s Drexel Burnham Lambert: the collateralized debt obligation (CDO).\textsuperscript{1938} From 2004 to 2008, arrangers issued over $1.4 trillion worth of CDOs.\textsuperscript{1939}

Originally, a CDO was a security that consisted of “a collection of just about anything that generate[d] a yield – bank loans, junk bonds, emerging market debt” and other types of financial products.\textsuperscript{1940} One of the most important differences between mortgage-backed securities and CDOs is that the former is backed by mortgages, whereas the latter is backed by different kinds of securities, including mortgage-backed securities.\textsuperscript{1941} CDOs are the product of “second level” securitizations, that is, those that invest in previous securitizations.\textsuperscript{1942}

Arrangers had the insight that CDOs could serve as “the investor” for less popular mezzanine tranches of their mortgage-backed securities.\textsuperscript{1943} In a process that mirrored the securitization of pools of subprime mortgages, arrangers would initially aggregate hundreds or even thousands of their issued mortgage-backed securities that featured lower investment-grade tranches, many of which were rated A or BBB (Bbb).\textsuperscript{1944} Next, they would re-tranche the pool of securities and then submit them once again to one of the three largest NRSRO’s for a credit rating evaluation.

In an extraordinary case of legerdemain, the NRSRO’s ultimately rated approximately 70% to 80% of these new CDO tranches triple-A, despite the fact that they were, in general, comprised of previously lower-rated tranches of mortgage-backed

\textsuperscript{1938} Ibid., 129.
\textsuperscript{1939} Wall Street and the Financial Crisis: Anatomy of a Financial Collapse, 318.
\textsuperscript{1940} Bethany McLean and Joe Nocera, All the Devils are Here: The Hidden History of the Financial Crisis, 120.
\textsuperscript{1942} Ibid., 4.
\textsuperscript{1944} Ibid.
According to the Financial Crisis Inquiry Commission, the apparent diversification of the new CDO tranches was the driving force behind many of the NRSRO’s CDO credit rating decisions. Due to the fact that there were more, say, previously BBB-rated tranches in given CDO than there were in a given mortgage-backed security, the tranches in the CDO deserved a higher credit rating than those in the mortgage-backed security, since the sheer number of the former posed a lesser overall threat of borrower default than the latter. 

Bethany McLean and Joe Nocera argue that this process was “a deeply perverse” sort of “alchemy.” The two authors describe this transformation as “ratings laundering,” a process by which the origins of previously unpopular, lower-rated tranches of mortgage-backed securities were concealed by newly bestowed, though unjustified, triple-A CDO ratings. One unnamed Wall Street executive likened CDOs to “purifying uranium until you get to the stuff that’s the most toxic.” Patricia McCoy and Kathleen Engel conclude that “CDOs purported to make steak out of chicken.”

One should not overlook the crucial fact that arrangers wanted to have as many of their CDO tranches rated triple-A as possible. Compared to riskier CDO tranches, triple-A-rated, senior tranches carried a lower interest rate since they were perceived to

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1945 Ibid.
1946 Ibid., 128.
1947 Ibid. David Farber argues that the three largest NRSROs discerned diversification advantages in CDO tranches from other sources as well. For example, the underlying mortgages to which tranches of CDOs referred tended to be originated by a more diverse set of lenders when compared to those contained in a stand-alone mortgage-backed security. For other examples of how tranches of CDOs were supposedly imbued with greater diversification attributes than tranches of mortgage-backed securities, please see: David Faber, And Then the Roof Caved In: How Wall Street’s Greed and Stupidity Brought Capitalism to Its Knees (Hoboken: John Wiley & Sons, 2009), 102.
1948 Bethany McLean and Joe Nocera, All the Devils are Here: The Hidden History of the Financial Crisis, 122-123.
1949 Ibid., 122.
1950 Ibid., 123.
1951 Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps, 52.
1952 The same holds, of course, for their mortgage-backed securities as well.
be safer investments. Subprime mortgages tended to have compellingly higher interest rates than those that arrangers would have to pay out to investors in a senior tranche of one of their CDOs. Triple-A-rated tranches were attractive, therefore, not only to investors, but also to arrangers, for the latter could keep the spread between the incoming mortgage payments received from borrowers and the (lower) interest payments provided to investors in those tranches.1953

An illustrative, though overly-simplistic, example may be germane here.1954 Imagine that an arranger purchases two separate pools of subprime loans from a lender, one having a total value of $60 million (what will become MBS A), the other having a total value of $40 million (what will become MBS B). Separately, the arranger slices both pools into tranches, and then places them into a SPV. Suppose that one of the three largest NRSRO’s then gives a triple-A rating to the highest or senior tranche of both MBS A and B. The triple-A-rated senior tranche of MBS A is backed by $40 million of its pool’s $60 million worth of subprime loans, while the triple-A-rated senior tranche of MBS B is backed by $20 million of its pool’s $40 million worth of subprime loans. Impressively, this securitization has produced two separate “safe” investment opportunities worth a total of $60 million out of $100 million worth of risky subprime mortgages.

Unfortunately, the arranger still has $40 million worth of “residuals” or mezzanine tranches of subprime mortgage-backed securities that are too risky to satisfactorily attract the capital of investors. Anxious to securitize those unwanted, risky

1953 David Faber, And Then the Roof Caved In: How Wall Street's Greed and Stupidity Brought Capitalism to Its Knees, 97.
tranches a second time into a CDO, the arranger combines the leftover $20 million worth of subprime tranches from MBS A with the $20 million from MBS B. The arranger re-tranches this combined $40 million pool of risky subprime securities and submits them once again to one of the three largest NRSRO’s. This time, the highest rated tranche of the CDO earns a triple-A rating and is backed by $30 million worth of risky subprime mortgage-backed securities, which, in turn, are backed by $30 million worth of risky subprime mortgages. The arranger is now only left with $10 million worth of unattractive CDO tranches and has produced $90 million worth of triple-A-rated securities from $100 million worth of risky subprime mortgages.

This example is not intended to remotely serve as an exhaustive or even realistic depiction of a CDO securitization. For the purposes of this study, however, the example hopefully helps clarify how arrangers, with the invaluable assistance of the three largest NRSRO’s, were able to create the perception that risky subprime mortgages were reasonable and safe investments. Incredibly, arrangers eventually also created CDOs² and CDOs³. CDOs² were created out of pooled and tranched CDOs, while CDOs³ were structured out of pooled and tranched CDOs².\textsuperscript{1955} Aaron Unterman maintains that ultimately 85% of the tranches of securitized CDOs² received a triple-A rating.\textsuperscript{1956} I will now examine Wall Street’s leading CDO underwriter from 2004 to 2007, Merrill Lynch, to make this discussion more explicit.

\textsuperscript{1955} Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps, 52.
4.6. The Spectacular Decline of Merrill Lynch

Merrill Lynch, an arranger that is perhaps best known for its symbol of the bull and its enormous “thundering herd” of “16,000 brokers pitching stocks to retail investors,” was internally known around the turn of the twenty-first century as “Mother Merrill.” The derisive nickname stemmed from the perception that the arranger “was willing to accept lower profit margins in order to keep longtime loyal employees on the payroll.” At least part of the arranger’s corporate culture at this time emerged from the original vision of its founder, Charlie Merrill. In 1914, when Merrill Lynch was founded, Merrill had a “notion of how to succeed on Wall Street [that] was completely different from anyone else’s at the time.” He made it “his lifelong crusade” to bring “Wall Street to Main Street” by generating profits through selling stocks and bonds to the American middle class. One of Merrill Lynch’s slogans was that the arranger was “Bullish on America.”

In 2002, Stanley O’Neal was appointed CEO of Merrill Lynch and he immediately sought to eradicate this “Mother Merrill” culture, which he believed resisted change and protected underachievers. As Greg Farrell explains, “O’Neal wanted Merrill Lynch to be a lean and mean profit-oriented bank, along the lines of Goldman Sachs. Joe Nocera and Bethany McLean note that, prior to O’Neal’s appointment as

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1959 Ibid.
1960 All the Devils are Here: The Hidden History of the Financial Crisis, 159.
1961 Ibid.
1962 Ibid.
1964 Ibid.
CEO, Merrill Lynch “was never held in the same esteem as Morgan Stanley and Goldman Sachs.”\textsuperscript{1965} The two authors further observe that Goldman Sachs was able to make more money with fewer employees than Merrill Lynch, all the while dealing with “sexy hedge funds and counterparties rather than middle-class Americans.”\textsuperscript{1966} Due to a combination of these factors, the two authors argue, “there was no firm suffering from a worse case of Goldman envy than Merrill Lynch” in the early 2000’s.\textsuperscript{1967}

Newly minted as the CEO of Merrill Lynch, O’Neal immediately aspired to match the trajectory of Goldman Sachs’ growth. Part of his strategy was to establish a stronghold in the CDO market.\textsuperscript{1968} In 2002, Merrill Lynch was the 15\textsuperscript{th} largest underwriter of CDOs, arranging $2.22 billion worth of CDO deals.\textsuperscript{1969} The next year, the arranger hired Christopher Ricciardi, who liked to be called “the grandfather of CDOs,” to help transform the company into “the Wal-Mart of the CDO industry.”\textsuperscript{1970} By 2004, Merrill Lynch became the largest arranger of CDOs on Wall Street, having arranged $19 billion worth of CDO deals that year.\textsuperscript{1971} In 2005, Merrill Lynch once again secured the top spot on Wall Street as the largest arranger of CDO deals, completing an incredible $35 billion worth of them. Of those $35 billion worth of CDOs, $14 billion were backed by subprime MBSs.\textsuperscript{1972}

It is important to note that arranging CDO deals was a profitable endeavor leading up to the subprime mortgage crisis, so much so that the arranger found the enterprise to

\textsuperscript{1965} All the Devils are Here: The Hidden History of the Financial Crisis, 159. \\
\textsuperscript{1966} Ibid., 160. \\
\textsuperscript{1967} Ibid. \\
\textsuperscript{1968} Randall Smith, “O’Neal Out as Merrill Reels from Loss – Startled Board Ditches a Famously Aloof CEO; The Revenge of ‘Mother’.” \\
\textsuperscript{1969} Serena Ng and Carrick Mollenkamp, “Merrill Takes $8.4 Billion Credit Hit --- It Plunged Into CDOs In ‘03, Hiring Pioneer Of the Debt Securities,” The Wall Street Journal (October 25, 2007). \\
\textsuperscript{1970} Ibid. \\
\textsuperscript{1971} Ibid. \\
\textsuperscript{1972} Ibid.
be “too lucrative to give up.”1973 For each CDO that it underwrote, Merrill Lynch would earn fees ranging anywhere between 1% and 1.5% of the deal’s total size. A typical $1 billion CDO deal, for instance, would generate $15 million in fees for the arranger.1974 According to one estimate, Ricciardi’s team earned $400 million in profits for the arranger in 2005.1975 Merrill Lynch also acquired revenue by keeping large volumes of triple-A rated CDOs on its books, “thinking they were low-risk assets because of their top credit ratings.”1976

Near the end of 2005, many investors began to feel that they had invested enough money in subprime MBSs and tranches of CDOs.1977 Moreover, AIG made the troubling announcement that it would no longer sell credit protection on tranches of subprime CDOs. This was arguably the pivotal moment for Merrill Lynch. As an insightful article in The Wall Street Journal notes, “Merrill was used to having to keep lots of mortgage bonds and pieces of CDOs on its books temporarily before selling them. But without a firm like AIG providing credit insurance, Merrill had to bear the risk of default itself.”1978

In a later section, I will examine AIG’s relationship with the various arrangers in more detail. For now, one should note that Merrill Lynch was confronted by a question of paramount importance at the end of 2005: Should it continue aggressively pressing ahead, arranging increasingly more profitable subprime CDO deals, or should it instead

1975 Serena Ng and Carrick Mollenkamp, “Merrill Takes $8.4 Billion Credit Hit --- It Plunged Into CDOs In ’03, Hiring Pioneer Of the Debt Securities.”
1976 Randall Smith and Jed Horowitz, “Merrill Takes $8.4 Billion Credit Hit --- O’Neal Faces Grilling As Loss Tops Forecast; Stock Price Falls 5.8%.”
1977 Ibid.
construe AIG’s decision as a warning to scale back on those operations? One potential pitfall of preserving its imposing presence in the CDO market was that the arranger would have to assume, at least temporarily, the credit risk on future tranches of subprime CDOs that it underwrote.

In an effort to examine this dilemma more closely, one should consider the following example. In August of 2006, Merrill Lynch underwrote a $1.5 billion CDO called “Octans.” Although the arranger successfully found investors to take on the risk of the $525 million worth of mezzanine tranches, it could not sell or insure the remaining $975 million worth of super-senior tranches. As a result, a Merrill Lynch trader was confronted by the question of whether the arranger should take on the credit risk of the $975 million super-senior tranches, or let the deal fall through. Merrill Lynch’s CDO co-chief, Harin De Silva, urged the trader to accept the tranches and their accompanying credit risk because otherwise the arranger would take on the credit risk of all of the tranches since the deal would not be completed. Even though the trader admitted that he was not comfortable taking on the credit risk of the super-senior tranches because “he didn’t know enough about the CDO,” Merrill Lynch ultimately accepted the tranches, closed the deal, and earned $15 million in fee revenue.\textsuperscript{1979}

In the end, the fees generated by arranging CDO deals were simply too seductive for Merrill Lynch to resist. It is likely that, before the subprime mortgage crises began to unfold in 2007, the arranger could have sold off billions of dollars worth of subprime MBSs that it intended to later package into CDOs for a cumulative loss of $1.5 to $3

\textsuperscript{1979} Ibid.
billion. Instead of choosing to endure those short-term losses, however, Merrill Lynch elected to put its CDO business into “overdrive.”1980

In 2006, a year in which the term “CDO” did not once appear in its annual report,1981 Merrill Lynch issued an astounding $52.4 billion worth of CDOs,1982 $44 billion of which were tranches of CDOs backed by subprime MBSs.1983 Arranging these CDO deals generated fee revenues of approximately $700 million for the arranger.1984 Merrill Lynch went further by eventually dismissing Jeffrey Kronthal, a CDO risk manager, in the middle of the year for reportedly imposing “informal limits on the amount of CDO exposure the firm could keep on its books ($3bn to $4bn) and on its risk of possible CDO losses (about $75m a day).”1985 In his place, Merrill Lynch appointed a senior trader, Ranodeb Roy, who did not have “much experience in mortgage securities.”1986 As reported by The Wall Street Journal:

CDO holdings on Merrill’s books were soon piling up at a rate of $5bn to $6bn per quarter. This led to an inside joke at Merrill. Roy is known as Ronnie. Some employees took to saying that if they couldn’t find a specialized bond insurer, known as a “monoline,” to take Merrill’s risk on the deal, they could resort to a “Ronoline.”1987

By September of 2006, the arranger had on its own books $17 billion in tranches of subprime CDOs, $18 billion of subprime MBSs ready to be packaged into CDOs, and $14 billion of subprime loans waiting to be securitized into MBSs. Additionally, Merrill...

1980 Ibid.
1983 Randall Smith and Jed Horowitz, “Merrill Takes $8.4 Billion Credit Hit --- O’Neal Faces Grilling As Loss Tops Forecast; Stock Price Falls 5.8%.”
1984 Susan Pulliam, Serena Ng, and Randall Smith, “Merrill Upped Ante as Boom in Mortgage Bonds Fizzled.”
1985 Ibid.
1986 Ibid.
1987 Ibid.
Lynch was simultaneously in the process of making arrangements with lenders to finance another $22 billion worth of subprime loans. That month, the arranger’s “investments and financing related to subprime mortgages and CDOs” exceeded its total stock market value. Risks of this sort paid off for Merrill Lynch for about four years, as its annual profits from 2003 to 2006 more than doubled to an average of $5 billion. Yet, as one observer notes, the arranger was playing “a terrible game of musical chairs.” This gambit only worked as long as investor demand for subprime-related securities persisted.

David Faber nicely captures the sentiment surrounding Merrill Lynch as 2006 came to a close:

As Merrill headed into 2007, it had record earnings, a strong stock price, well-paid executives, a confident board of directors, and a mission to get even bigger in the one area that had been so instrumental to all its success: mortgages. It wanted to originate more mortgages, buy more mortgages, package more mortgages into securities, and package more of those securities into CDOs. And of course, it wanted to sell those securities and CDOs as fast as it possibly could, because that’s where the money was. It was also happy to keep increasing the leverage on its balance sheet as its assets ballooned past $1 trillion, driven by the addition of all those mortgages.

As late as the end of the second quarter of 2007, with the subprime mortgage market already buckling under the weight of borrower delinquencies and defaults, Merrill Lynch posted impressive earnings. Right around the time of this earnings announcement, however, the financial condition of the arranger swiftly deteriorated. In mid-July of 2007, Merrill Lynch’s board of directors was alerted that it may end up suffering losses of $500

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1989 Randall Smith, “O’Neal Out as Merrill Reels from Loss – Startled Board Ditches a Famously Aloof CEO; The Revenge of ‘Mother’.”
1990 And Then the Roof Caved In: How Wall Street's Greed and Stupidity Brought Capitalism to Its Knees, 166.
1991 Ibid., 132.
million from poorly performing mortgage-related assets. In response to this news, Stanley O’Neal sent a memo out at the end of the month to the 62,000 Merrill Lynch employees that said, “We’re very comfortable with our current exposure to this asset class.”

Around the same time, Merrill Lynch’s Chief Financial Officer, Jeff Edwards, stated in a conference call with investors that the arranger’s exposure to subprime mortgages was “limited, contained, and appropriate.”

On August 9, 2007, the board received a memo that estimated the arranger would now suffer $1 billion of losses from mortgage-related assets. Roughly two months later, on October 5, Merrill Lynch announced that it would actually lose $5 billion from those assets. Ultimately, on October 24, Merrill Lynch revealed that it suffered massive losses totaling $8.4 billion from those assets and other write-downs. At the time, it was the single largest known Wall Street loss. On October 30, Stanley O’Neal resigned and was expected to receive approximately $160 million in severance and retirement payments. The next month, on November 15, 2007, Merrill Lynch announced the hiring of John Thain as its new CEO, which, according to The Wall Street Journal, signaled “that after years of inner turmoil and risky expansion, the beleaguered financial giant want[ed] a pair of steady hands at the helm.”

It later surfaced that, as the subprime mortgage market was imploding, Merrill Lynch audaciously issued $30 billion worth of CDOs that were backed by risky

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1993 Lisa Kassenaar and Yalman Onaran, “Merrill’s Repairman.”
1994 Randall Smith, “Merrill's $5 Billion Bath Bares Deeper Divide --- After Big Write-Down Tied to Mortgage Debt, O'Neal Asserts Control.”
1995 Randall Smith and Jed Horowitz, “Merrill Takes $8.4 Billion Credit Hit --- O’Neal Faces Grilling As Loss Tops Forecast; Stock Price Falls 5.8%.”
mortgages over the first seven months of 2007. The arranger was also a pioneer in issuing CDOs² and CDOs³. It is interesting to see how a late-2007 article written in *The Wall Street Journal* attempted to describe what Merrill Lynch was doing before the terms “CDOs²” and “CDOs³” became more popular. As the authors of the article note, “[T]he bulk of the middle-rated pieces of CDOs underwritten by Merrill were purchased by other CDOs that the investment bank arranged... Each CDO sold some of its riskier slices to the next CDO, which then sold its own slices to the next deal, and so on.” The authors proceed to perceptively call attention to how this strategy was artificially propping up the prices of CDOs.

The troubled arranger ultimately ended up issuing $144.95 billion worth of CDOs from 2003-2007. Isolating the losses stemming directly from Merrill Lynch’s buying, packaging, and selling financial products made from subprime mortgages, the arranger lost an astonishing $23.2 billion by the end of 2007. To provide a sense of the extent of the risks that Merrill Lynch bore during this time, the arranger had $1.02 trillion worth of assets with equity of only $31.566 billion. Thus, a mere 3% drop in the value of those assets would have completely wiped out the arranger’s equity capital. In the next section, I will explore why Merrill Lynch and the other large arrangers were able to take on such dangerously high levels of leverage.

1998 Susan Pulliam, Serena Ng, and Randall Smith, “Merrill Upped Ante as Boom in Mortgage Bonds Fizzled.”
2000 Ibid.
2002 *And Then the Roof Caved In: How Wall Street's Greed and Stupidity Brought Capitalism to Its Knees*, 166.
2003 Ibid., 167.
Over the course of the fourth quarter of 2007 and the first quarter of 2008, Merrill Lynch raised approximately $13 billion by issuing shares of common and preferred stock. Complementing his efforts to raise capital, Thain also adopted certain cost cutting measures, such as replacing “fresh flowers on a Merrill floor used by nine or so executives – an estimated annual expense of $200,000 – with fakes.” The CEO also cut 15% of its workforce in early 2008. These efforts, however, proved to be far from sufficient and were partially undermined by Thain’s decision to spend over $1.22 million on remodeling expenses, including the purchase of an $87,000 area rug for his office.

By July of 2008, the arranger was compelled to acknowledge that $30.6 billion of its CDOs were “worth barely a fifth of their original price.” As a result, Merrill Lynch sold those CDOs to Lone Star Funds for $6.7 billion, or for about 22 cents on the dollar. That same month, Merrill Lynch posted a loss of $4.65 billion for the second quarter, its third straight quarter of losses, which kept alive its longest and worst losing streak in its 94-year history. To keep afloat, Merrill Lynch issued $8.5 billion worth of common stock, which diluted existing shareholders by about 38%. The arranger also began selling valuable assets to raise capital, such as its 20% stake in

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2004 Ibid.
2010 Ibid.
2011 Susan Pulliam, Serena Ng, and Randall Smith, “Merrill Upped Ante as Boom in Mortgage Bonds Fizzled.”
Bloomberg LP. Describing the perilous situation at Merrill Lynch, one analyst observed, “Revenue is going down, expenses can’t go down fast enough, and [it] is now selling the sofa to pay the rent -- and next month it will be the dining-room table.”

By August of 2008, Merrill Lynch’s losses over the previous 18 months had equaled approximately 25% of the profits that the arranger had enjoyed over the previous 36 years. As late as September 10 of that year, Thain was “still out promoting Merrill in public and assuring employees that things would work out well.” Three days later, Thain and the CEO of Bank of America, Kenneth Lewis, began discussing the possibility of the bank acquiring the arranger. On September 15, 2008, the day of the Lehman Brothers bankruptcy, Bank of America agreed to acquire Merrill Lynch for a little over $50 billion. In response to the acquisition, Thain declared, “We have over 60,000 people working every day. All the efforts of these people were overwhelmed by the write-downs in the mortgage-related assets.”

In the middle of October of 2008, well-before the acquisition was finalized, the arranger posted another crushing quarterly loss of $5.15 billion. About two months later, on December 5, 2008, both Merrill Lynch and Bank of America shareholders

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2015 The Financial Crisis of Our Time, 100.
2016 Ibid.
approved the acquisition,\textsuperscript{2020} which was eventually finalized on January 1, 2009.\textsuperscript{2021} After roughly a year and a half of severe mortgage-related losses, Merrill Lynch’s “storied but tarnished 94-year history as an independent company” came to an abrupt close.\textsuperscript{2022}

Soon after the acquisition was completed, it was revealed that Merrill Lynch endured a stunning $15.31 billion fourth quarter 2008 loss.\textsuperscript{2023} Coincidentally or not, this news broke on the same day that the United States Treasury Department and the Fed announced that they were lending “$20 billion in fresh capital” to Bank of America and guaranteeing an incredible $118 billion worth of Merrill Lynch’s weakest assets.\textsuperscript{2024} Bank of America had just recently, on November 26, 2008, secretly borrowed $86 billion from the Federal Reserve.\textsuperscript{2025} Eliciting intense public outcry, it was unveiled in February of 2009 that Merrill Lynch, after losing a total of $27 billion in 2008, paid nearly 700 of its employees year-end bonuses of $1 million or more.\textsuperscript{2026}

\textsuperscript{2020} Jessica Papini and Marshall Eckblad, “Crisis on Wall Street: It's a Done Deal: Merrill and BofA --- At Thundering Herd's Last Meeting, Thain Presides Over Sadness and Anger,” \textit{The Wall Street Journal} (December 6, 2008).


\textsuperscript{2022} Jessica Papini and Marshall Eckblad, “Crisis on Wall Street: It's a Done Deal: Merrill and BofA --- At Thundering Herd's Last Meeting, Thain Presides Over Sadness and Anger.”

\textsuperscript{2023} Ibid.


\textsuperscript{2025} Bob Ivry, Bradley Keoun, and Phil Kuntz, “Secret Fed Loans Gave Banks $13 Billion Undisclosed to Congress,” \textit{Bloomberg News} (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. The authors note in this article that, on the same day that Bank of America accepted the $86 billion in emergency loans, then-CEO Kenneth Lewis assured Bank of America’s shareholders that the company was “one of the strongest and most stable major banks in the world.”

4.7. The SEC’s Adoption of the Alternative Net Capital Rule and the Explosion of Leverage

One may wonder how the large arrangers, such as Merrill Lynch, were able to irresponsibly take on such risks in the first place. In a groundbreaking article, Stephen Labaton, writing for The Washington Post shortly after the collapse of Lehman Brothers and Washington Mutual, the rescue of AIG, and the placement of Fannie Mae and Freddie Mac into conservatorship, provided a huge piece of the puzzle. Labaton wrote in October of 2008:

Many events in Washington, on Wall Street and elsewhere around the country have led to what has been called the most serious financial crisis since the 1930s. But decisions made at a brief meeting on April 28, 2004, explain why the problems could spin out of control. The [SEC’s] failure to follow through on those decisions also explains why Washington regulators did not see what was coming.2027

At that sparsely attended proceeding, one that was not even covered by any of the major media outlets, five members of the SEC met to discuss “an urgent plea” that had been made by the five largest arrangers: Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers and Bear Stearns.2028

As explained by Labaton, at the time of the meeting, the European Union (EU) was about to impose additional, stricter regulatory burdens on the foreign subsidiaries of United States investment banks. These regulations were part of the EU’s Financial Conglomerates Directive of 2002, and they included the implementation of higher capital requirements that the five arrangers wanted to avoid.2029 The EU maintained, however,
that if the SEC regulated the parent companies of those foreign subsidiaries, then those subsidiaries would be exempt from their forthcoming regulations.2030

This loophole was obstructed by the fact that the SEC did not have explicit authority to oversee the parent companies. The Gramm-Leach-Bliley Act of 1999 gave the SEC the authority to supervise only the securities and brokerage units of holding companies, not the parent companies themselves.2031 The solution to this quandary was settled in 55 minutes at the April 28, 2004 meeting, when the SEC unanimously approved the awkwardly titled “consolidated supervised entities” program,2032 one that was accompanied by the adoption of the “alternative net capital rule.”2033

In order to qualify as a consolidated supervised entity, the SEC stipulated that a holding company had to have at least $5 billion in assets. As Patricia McCoy and Kathleen Engel note, Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers, and Bear Stearns were the only independent arrangers that were able to meet that requirement.2034 Disturbingly, all five of them heavily lobbied for the creation of the program.2035

Under the 2004 program, the SEC agreed to implement the alternative net capital rule, which removed the previous leverage ratio of fifteen for the five consolidated supervised entities’ brokerage units.2036 Before the program was approved, the five

2032 Ibid.
2033 The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps, 209.
2034 Ibid.
2035 Stephen Labaton, “S.E.C. Concedes Oversight Flaws Fueled Collapse.”
2036 Much of this narrative has been disputed. For example, as William Cohan contends, “[T]he truth is that in recent decades, Wall Street firms have almost always been highly leveraged. For instance, according to a 1992 study by the U.S. General Accounting Office (now the Government Accountability Office), the average leverage ratio for the top 13 investment banks was 27-to-1 midway through 1991…. [I]n 1998, the
arrangers’ brokerage houses were subjected to a leverage ratio that allowed them to borrow only $15 for every $1 in capital that they held.\textsuperscript{2037} The alternative capital rule exclusively permitted the five arrangers to “set their own leverage ceilings, using their [own] internal mathematical models.”\textsuperscript{2038} In return for this benefit, the five arrangers agreed to submit their parent holding company and all of their unregulated affiliates “to voluntary SEC examination and supervision.”\textsuperscript{2039} Among the many important consequences that followed from this arrangement, one should especially note that the SEC could not require the five arrangers to raise additional capital should the former determine that the latter were taking excessive risks. For instance, it was eventually revealed that the SEC was well-aware of the troubling risks that Bear Stearns was taking before its collapse, but the regulatory body simply inquired whether the arranger was intending to raise capital. The SEC did not have the authority to force Bear Stearns to do so.\textsuperscript{2040} It is necessary to briefly examine the power and perils of leverage and then explore how this questionable quid pro quo ultimately played out.

Simply put, leverage is attractive because it can amplify returns.\textsuperscript{2041} Patricia McCoy and Kathleen Engel’s example of the buying and selling of a home is a helpful illustration of the power of leverage. Imagine Homebuyer A has $200,000 in cash and decides to purchase a home for that amount. A few years later, the house appreciates and

\begin{footnotesize}
\begin{enumerate}
\item The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps, 209. Italics mine.
\item Ibid.
\item Ibid. Italics mine.
\item Ibid. Italics mine.
\item The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps, 208.
\end{enumerate}
\end{footnotesize}
he is able to sell the house for $220,000. In this case, his return on the “leverage-less” investment of the house is 10% or $20,000. However, suppose that Homebuyer B only has $20,000 in cash and elects to take out a zero-percent, no-cost mortgage in the amount of $180,000 to purchase the same $200,000 house. Homebuyer B would have a leverage ratio of nine. A few years later, like Homebuyer A, he is able to sell the house for $220,000. In this second scenario, his return on the leveraged investment of the house is 100%, a $20,000 return on his $20,000 investment.2042

If Homebuyer A and B’s houses decrease in value, one can also discern part of the danger of leveraged investments. This time, suppose both Homebuyer A and B’s houses lose 20% of their purchase price and necessity demands that they both sell their houses for a loss. Homebuyer A, though absorbing a loss of $40,000, is still able to walk away with $160,000 of his investment. Homebuyer B with his leverage ratio of nine, on the other hand, has not only lost 100% of his investment, but he is also on the hook for another $20,000 that he still owes his mortgage lender.

Returning to the impact of the 2004 SEC program, the five arrangers, having had the caps on their leverage ratios removed by the alternative net capital rule, proceeded to go on a leverage binge, borrowing billions of dollars to purchase subprime MBSs, CDSs, and other exotic instruments.2043 In 2007, Morgan Stanley had an astonishing leverage ratio of 35, with the leverage ratios of Merrill Lynch and Goldman Sachs close behind at 31.9 and 28, respectively. Bear Stearns, during the week that it collapsed in the middle of March of 2008, had a leverage ratio of 35. Later that same month, the soon-to-be-

\footnotesize 2042 Ibid.
bankrupt Lehman Brothers had a leverage ratio of 31.7.\textsuperscript{2044} On September 26, 2008, SEC Chairman Christopher Cox terminated the consolidated supervised entities program, while publicly announcing that the program was “fundamentally flawed from the beginning.”\textsuperscript{2045} The chief flaw of the program, according to Cox, was that the five arrangers “could opt in or out of supervision voluntarily.”\textsuperscript{2046}

4.8. Repurchase Agreements Compounded the Risks Posed by Leverage

It is important to note that these five consolidated supervised entities were able to borrow significant sums of money, and hence boost their leverage, by using the MBSs and tranches of CDOs on their books as collateral. They were able to borrow money this way by making repurchase agreements or “repos” with willing lenders, who were frequently their fellow arrangers. As Peter Wallison explains, in a repo transaction, a borrower “sells a security to a lender with an option to repurchase it at a price that provides the lender with a return appropriate for a secured loan.”\textsuperscript{2047} Typically, these loans were over-collateralized, meaning that the loan amounts were less than the full value of the collateral that secured them.\textsuperscript{2048} Should the borrower be unable to repurchase the security at a future time, the lender could presumably sell the security to recover the lost money that it had lent and pocket the difference. To give one a sense of the size of

\textsuperscript{2044} The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps, 209.
\textsuperscript{2045} Mark Pittman, Elliot Blair Smith, and Jesse Westbrook, “Cox’s SEC Censors Report on Bear Stearns Collapse.”
\textsuperscript{2046} Ibid.
the repo market once the subprime crisis began to unfold, the average daily volume of
this market was $2.4 trillion in 2007.\textsuperscript{2049}

Leading up to the outbreak of the crisis, the repo market was “a decades-old, plain-vanilla market [that was] critical to the smooth functioning of capital markets.”\textsuperscript{2050} However, the dangers of using MBSs and tranches of CDOs as collateral in order to obtain short-term funding, which, in turn, would be promptly employed to finance one’s day-to-day business operations, were overshadowed by a sector-wide overconfidence in the strength of the residential mortgage market. When housing prices began to decline in 2007, and mortgage delinquencies subsequently surged, a key funding source for the five arrangers and other participants in the financial sector began to dry up.\textsuperscript{2051} As FDIC chair Sheila Bair observed:

As home prices fell, recently originated subprime and non-traditional mortgage loans began to default at record rates. These developments led to growing concerns about the value of financial positions in mortgage-backed securities and related derivative instruments held by major financial institutions in the U.S. and around the world. The difficulty in determining the value of mortgage-related assets and, therefore, the balance-sheet strength of large banks and non-bank financial institutions ultimately led these institutions to become wary of lending to one another, even on a short-term basis.\textsuperscript{2052}

A snapshot of this phenomenon can be discerned in the swift and dramatic collapse of Bear Stearns in March of 2008.

Of the five arrangers, Bear Stearns had the most exposure to subprime loans.\textsuperscript{2053}

\textsuperscript{2049} Ibid., 284.
\textsuperscript{2053} \textit{The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps}, 88.
The investment bank issued $10.097 billion worth of subprime MBSs in 2000, followed by $6.748 billion in 2001, $9.336 billion in 2002, $10.783 billion in 2003, $13.095 billion in 2004, $12.854 billion in 2005, $11.169 billion in 2006, and $13.360 billion in 2007. Leading to the eruption of the subprime mortgage crisis, the arranger had a “longstanding” relationship with the notorious subprime lender, New Century Financial, which consisted of the former financing and purchasing risky mortgage loans from the latter. Bear Stearns also owned and operated a residential mortgage loan subsidiary, EMC Mortgage, to assist with accelerating its subprime securitizations. In October of 2006, the arranger purchased another subprime lender, Encore Credit Corporation. Jeff Verschleiser, a senior managing director in Bear Stearns’ mortgage department, affirmed that the acquisition would enable the investment bank to have “a substantial stake in the subprime lending business.”

In early autumn of 2007, Bear Stearns owned a stockpile of mortgages and mortgage-related securities valued at approximately $56 billion. On December 20 of that year, the arranger, burdened by losses in its mortgage inventory, announced its first quarterly loss in 85 years of existence. Nearly three months later, on March 10, 2008, Moody’s downgraded fifteen MBSs underwritten by Bear Stearns, announcing that the downgrades were based on “higher-than-anticipated rates of delinquency [and]

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2054 Compass Point Research & Trading LLC, Mortgage Finance: Mortgage Repurchases Part II: Private Label RMBS Investors Take Aim – Quantifying the Risks, 8.
2058 Ibid.
foreclosure… in the underlying collateral.” 2059 The next day, on March 11, the Dutch bank ING Group announced that it was eliminating $500 million in short-term financing to Bear Stearns. 2060 On March 13, it surfaced that Bear Stearns had exhausted nearly 89% of its liquid assets in just three days, while additional lenders, such as Fidelity Investments, refused to enter into further repo transactions with the distressed investment bank. 2061

At this point, the situation was so dire for Bear Stearns that if it failed to obtain new financing before the markets opened on March 14, it would have to file for bankruptcy protection. That night, one Bear Stearns executive described the situation as “end of the world bad.” 2062 Bear Stearns’ CEO, Alan Schwartz, contacted JPMorgan seeking an emergency $25 billion line of credit. With the assistance of the Federal Reserve Bank of New York, JPMorgan crafted an overnight emergency loan. As Richard Kolb explains, “The exact terms of the loan were not immediately disclosed, but they boiled down to the Fed extending a line of credit of about $30 billion [to Bear Stearns] for 28 days.” 2063 Interestingly, the deal stipulated that JPMorgan would not actually lend Bear Stearns any money. Instead, it would serve as a conduit through which the Fed would funnel funds to Bear Stearns. At this stage in the crisis, “the Fed believed that it did not have the power to lend directly to an investment bank.” 2064

The next day, Friday, March 14, Bear Stearns’ stock price precipitously dropped 47%, closing at $30.00 per share. To put this share price in perspective, shares of Bear

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2060 Ibid., 27.
2061 Kate Kelly, “The Fall of Bear Stearns: Lost Opportunities Haunt Final Days of Bear Stearns — Executives Bickered Over Raising Cash, Cutting Mortgages.”
2063 Ibid.
2064 Ibid.
Stearns stock closed at $70.08 per share just one week earlier, and reached as high as $171.51 in 2007.2065 According to Kate Kelly, writing for *The Wall Street Journal*, then-Treasury Secretary Hank Paulson and then-President of the New York Fed Timothy Geithner contacted Schwartz that night, informing him that he needed “to have a deal by Sunday night.”2066 One person who was involved in the deliberations that weekend stated, “We thought [the Fed] gave us 28 days. Then they gave us 24 hours.”2067

After a hectic series of weekend negotiations between JPMorgan and Bear Stearns, the former offered the latter a purchase price of $2 a share on Sunday March 16.2068 After reading about the details of the offer in *The Wall Street Journal*, Morgan Stanley’s CEO at the time, John Mack, reportedly wondered aloud whether the $2 per share asking price was a typo that should have read $20.2069 Within a week, on Monday, March 24, JPMorgan raised its offer to $10 a share, accompanied by the condition that it would only have to absorb the first $1 billion of losses that could potentially result from $30 billion of Bear Stearns’ riskiest assets. As part of its effort to close the deal, the Fed agreed that it would guarantee the remaining $29 billion of those assets,2070 which Stephen Labaton aptly characterized as “a $29 billion taxpayer dowry.”2071

In the end, Bear Stearns failed for a variety of reasons. Among the most prominent of those reasons were its excessive subprime exposure, alarmingly high

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2065 Ibid., 91-94.
2068 *The Financial Crisis of Our Time*, 94.
2069 Kate Kelly, “The Fall of Bear Stearns: Bear Stearns Neared Collapse Twice in Frenzied Last Days --- Paulson Pushed Low-Ball Bid, Relented; a Testy Time for Dimon.”
2071 Labaton, “Agency’s ‘04 Rule Let Banks Pile Up New Debt, and Risk.”

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leverage ratio (as high as 35 to 1), and an overdependence on MBSs and tranches of CDOs to serve as collateral for acquiring short-term financing. In September of 2008, the SEC’s Inspector General conceded in a report that the SEC “became aware of numerous potential red flags prior to Bear Stearns’ collapse,” including the arranger’s “concentration of mortgage securities, high leverage, [and] shortcomings of risk management,” but nevertheless the regulator “did not take actions to limit these factors.”

I will now examine how another essential ingredient in the subprime mortgage crisis, credit-default swaps, greatly boosted the arrangers’ ability to securitize subprime MBSs and CDOs.

4.9. A Brief Introduction to Derivatives, Credit Derivatives, and Credit-Default Swaps (CDSs)

Derivatives have been around for over 4,000 years. Yet, despite their resilience, they resist a simple definition due to the fact that “they vary widely in content and application.” In general terms, derivatives are contracts “whose structures and values refer to financially meaningful external items.” The basis for their name stems from how they derive their content and value from certain external, more substantive things, commonly called “underlyings.”

Broadly speaking, underlyings “can be anything that interests markets,” ranging from cash instruments (such as stocks and bonds) to tangibles (such as commodities) to even intangibles (such an interest rates,
currency rates, or the credit quality of institutions).\textsuperscript{2078} A fluctuation in the value of a
given derivative’s underlyings will reverberate “up” to the level of that derivative,
causing its value to likewise change. A derivative shorn of its underlyings would have no
value at all.\textsuperscript{2079}

One of the fundamental functions of derivatives is to reallocate risk. As Norman
Menachem Feder explains:

\textquote{D}erivatives contracts isolate certain risks and move them from one party
to another. By engineering a contract whose value reflects in some way
the value or change in value of an underlying, parties can shift the risk
inherent in exposure to that underlying. Via judicious selection of
underlyings and thoughtful arrangement of relevant obligations,
parties to derivatives arrangements \textit{unbundle} specific risks and place each
of these risks where they are most welcome.\textsuperscript{2080}

It is important to mention that derivatives do not \textit{eliminate} underlying risks. Instead, they
simply shift or reposition certain risks from one party who does not want to be burdened
by them to another party who is willing to assume them.\textsuperscript{2081} One should further note that
derivatives enable investors to “place bets on the direction of markets, \textit{without ever
needing to actually own tangible assets in that market.”}\textsuperscript{2082} Long-recognized types of
derivatives include: options (the right to buy or sell something at a set price in the future),

\textsuperscript{2078} Ibid.
\textsuperscript{2079} Stephen J. Lubben, “Credit Derivatives and the Future of Chapter 11,” \textit{American Bankruptcy Law
\textsuperscript{2080} Norman Menachem Feder, “Deconstructing Over-the-Counter Derivatives,” 682, italics his.
\textsuperscript{2081} Ibid.
\textsuperscript{2082} John. T. Lynch, “Credit Derivatives: Industry Initiative Supplants Need for Direct Regulatory
2008), 1373. Italics mine. The fact that corporations are legally permitted to purchase CDS protection on
underlyings, but not legally required to actually own those underlyings, arguably created conditions that
welcomed excessive and deleterious risk-taking behaviors. As John Talbott observes, “There’s only $8
trillion of non-financial corporate debt outstanding. So how could there be $25 to $30 trillion in CDS
activity? The answer is there must be enormous speculation. The CDS market is not being used solely as a
hedging tool to protect me against the risks that my investment will sour; rather it’s being used to let
individuals and corporations make bets about who’s going to go bankrupt first.” Please see: John R.
Talbott, \textit{Survival Investing: How to Prosper Amid Thieving Banks and Corrupt Governments} (New York:
forwards (the obligation to buy or sell something at a set price in the future), and swaps (an agreement between two parties to exchange cash flows, or future cash payments, at specified intervals).\textsuperscript{2083}

One strain of derivatives that is especially pertinent to this study is credit derivatives, which are “privately negotiated contracts that allow a party to transfer the risk of default on a bond or loan to another party without transferring ownership [of that bond or loan].”\textsuperscript{2084} The express purpose of credit derivatives is to transfer credit risk, the risk that a borrower will default on its payments of principal and interest, from one party to another.\textsuperscript{2085} Although the buying and selling of credit risk protection was not a new development when credit derivatives began to emerge in the mid-1990’s,\textsuperscript{2086} what distinguished the product from preceding forms of credit protection was that it effectively delinked the credit protection from the underlying instrument to which it referred.\textsuperscript{2087}

This innovation enabled market participants to trade credit risk separately from the underlying instruments that were creating that risk, thus affording them with unprecedented opportunities to customize their exposure to those risks.\textsuperscript{2088} Credit derivatives permitted investors to unbundle the credit risk accompanying their investments from the other risks that those investments may have posed to them.\textsuperscript{2089}

\begin{itemize}
\item \textsuperscript{2085} Stephen J. Lubben, “Credit Derivatives and the Future of Chapter 11,” 409.
\item \textsuperscript{2086} Gillian Tett, Fool’s Gold: How the Bold Dream of a Small Tribe at J.P. Morgan Was Corrupted by Wall Street Greed and Unleashed a Catastrophe (New York: Free Press, 2009), 3.
\item \textsuperscript{2087} Norman Menachem Feder, “Deconstructing Over-the-Counter Derivatives,” 707.
\item \textsuperscript{2088} Ibid.
\end{itemize}
Simply stated, credit derivatives separated the interest on a debt from the risk that it would not be paid back.\textsuperscript{2090}

In theory, the invention of credit derivatives assisted investors with their risk management efforts.\textsuperscript{2091} Indeed, this was the sentiment of then-Federal Reserve Board Chairman Alan Greenspan in 2005. Greenspan publicly praised the virtues of credit derivatives by affirming that their development had “contributed to the stability of the banking system by allowing banks, especially the largest, systemically important banks, to measure and manage their credit risks more effectively.”\textsuperscript{2092}

Since the outbreak of the subprime mortgage crisis, the most common form of credit derivatives has been under intense media and regulatory scrutiny: credit-default swaps (CDSs). As derivatives, CDSs are contracts whose structures and values are derived from underlyings. As \textit{credit} derivatives, CDSs are contracts in which two parties, a “protection buyer” and a “protection seller,” isolate and place a value on the credit risk that self-selected, referenced underlyings carry with them.\textsuperscript{2093} The relevant underlyings referred to in a CDS transaction are typically debt obligations, commonly called “reference obligations,” incurred by a company or companies. The company or


\textsuperscript{2093} Norman Menachem Feder, “Deconstructing Over-the-Counter Derivatives,” 706-707.
companies responsible for the reference obligation contained within a CDS contract are usually known as “reference entities.”

As part of a CDS contract, the protection buyer is purchasing credit protection from the protection seller. In exchange for a periodic fee, the protection buyer is able to offload the credit risk that accompanies a given reference obligation and transfer it to the protection seller. What is being swapped in a CDS contract, then, is money in exchange for credit risk protection. Should a predetermined credit event occur, typically if the reference entity files for bankruptcy protection or otherwise defaults on its reference obligation, the protection seller is contractually committed to compensate the protection buyer. An example may be helpful here.

Suppose that Company X purchases $100 million worth of bonds issued by Company Y, and the bonds mature in five years. Shortly after the purchase, Company X decides that it wants to hedge its credit risk exposure on the bonds. Hedging is tantamount to protecting. Company X wants to put itself in a position where it will profit under future circumstances that, bereft of the credit protection, would otherwise cause it to sustain a loss. Consequently, Company X enters into a five-year, $100 million CDS with Company Z. In this example, Company X is the protection buyer, Company Z is the protection seller, Company Y is the reference entity, and the $100 million worth of bonds is the reference obligation.

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2096 The following example was borrowed from: William K. Sjostrom, Jr., “The AIG Bailout,” 948.
After some negotiating, Company X and Company Z agree that what constitutes a credit event in this CDS is if Company Y either files for bankruptcy protection or defaults on its bond payments.\(^9\) Company X and Company Z also agree upon the premiums that the former will pay the latter over the life of the CDS: Company X will pay Company Z $250,000 per quarter during the five-year term of the CDS. Finally, Company X and Company Z establish how the latter will compensate the former, should a credit event occur: Company Z will pay Company X $100 million, or the par value of the bonds, even though the credit event will likely cause the value of those bonds to drop well below $100 million.\(^0\)

After five years, a credit event never occurs. Company Z earned $5 million over the term of the CDS in exchange for taking on the credit risk accompanying the reference obligation. One can be reasonably sure that Company X, despite paying out the $5 million to Company Z, nevertheless earned more than that sum from the interest payments made by Company Y on its bonds. Thus, Company X enjoyed a profit from its purchase of Company Y’s bonds, though its net gain obviously would have been higher had it not purchased credit protection from Company Z. Still, Company X was able to customize its credit risk exposure by purchasing the CDS, in effect, enhancing the likelihood that it would receive its invested principal back with interest from Company Y.

As this example hopefully makes clear, CDSs resemble insurance contracts. Analogous to traditional insurance, CDSs hone in on certain events that are fraught with risk, and give a protection buyer the opportunity to shield itself from that risk. One could purchase health insurance, protecting oneself from the risk of illness or injury, just as one

\(^{9}\) Ibid.
\(^{0}\) Ibid.
could purchase a CDS, protecting oneself from the risk of a counterparty default. As Georgette Phillips points out, the analogy ultimately breaks down, however, because traditional insurance contracts typically only involve two parties: the insurer and the insured. CDSs involve at least three parties.\textsuperscript{2101} Furthermore, the protection buyer of a CDS does not need to own the reference obligation, an important point that is not apparent in the example above.

Company X does not actually have to buy Company Y’s bonds in order to purchase a CDS with Company Z, one that would shield it from the credit risk that Company Y poses to its creditors. In many cases, reference entities are not even aware of the fact that protection buyers are purchasing CDSs that include their debt obligations.\textsuperscript{2102} Unbeknownst to Company Y, Company X could buy a CDS on its bonds, simply as a way of speculating that Company Y’s credit condition will decline over the term of the CDS.\textsuperscript{2103} A CDS that offers a protection buyer credit protection on a reference obligation in which it does not own or have an insurable interest is known as a naked CDS.\textsuperscript{2104}

Reflecting on the nature of naked swaps, Michael Greenberger, a law professor at the University of Maryland, noted, “It’s sort of like I think you’re a bad driver and you’re going to crash your car… [s]o I go to an insurance company and get collision insurance

\textsuperscript{2102} Stephen J. Lubben, “Credit Derivatives and the Future of Chapter 11,” 411.
\textsuperscript{2103} The three primary uses of CDSs are for hedging, speculating, and arbitrage. Please see: Norman Menachem Feder, “Deconstructing Over-the-Counter Derivatives,” 717-721.
on your car because I think it’ll crash and I’ll collect on it.” 2105 As much as 80% of the CDS market is traded by investors who do not have an insurable interest in the underlying reference obligations. 2106 In addition to creating conditions rife for speculation on the performance on subprime MBSs and CDOs, naked swaps also created “daisy chains of liability,” which eventually magnified the losses caused by those financial products. 2107 Kathleen Engel and Patricia McCoy provide a helpful example to illustrate this point.

Imagine Company A purchases a subprime MBS and then, in an effort to protect itself from the credit risk that the bond poses, it elects to purchase a CDS from Company B. Once this transaction is completed, Company B decides that it wants to protect itself from the risk that it will have to compensate Company A should a credit event occur. Worried over this prospect, Company B purchases a CDS from Company C, protecting itself from the risk of having to compensate Company A. Then, Company C determines that it would like to purchase a CDS from Company D, one that would protect it from the risk of having to compensate Company B. One should note that only Company A has an actual insurable interest in the subprime MBS from which all of this credit protection proliferated.

If a credit event would happen to occur, Company A would demand compensation from Company B, Company B would demand compensation from Company C, and Company C would demand compensation from Company D. As the

2107 The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps, 219.
backstop protection seller, Company D’s inability to compensate Company C because the liability was too large could give rise to a domino effect of failures down the line. Company C, which was relying upon Company D to meet the obligations outlined in the CDS, is now on the hook to compensate Company B. If Company C defaults on its obligations to Company B, the latter would then be responsible for compensating Company A without the benefit of the compensation that it expected. This could cause Company B to default on its obligations to Company A, which could likewise doom the latter.2108 As Peter Wallison makes clear, these daisy chains of liability did not intrinsically magnify the risks posed by subprime MBSs and CDOs.2109 However, one could argue that they did dramatically heighten the importance of backstop CDS protection sellers making circumspect decisions. In a later section, the grave failings of the most important backstop CDS protection seller, AIG, will be explored. Michael Lewis labeled AIG the “subprime risk-taker of last resort.”2110

A second key difference between traditional insurance and the CDS market is that the latter is largely unregulated. The Gramm-Leach-Bliley Act of 1999 (GLBA) amended existing securities statutes and ended up exempting CDSs “from most aspects of federal securities law apart from the antifraud provisions.”2111 Senator Phil Gramm added a clause to GLBA that “prohibited states from regulating swaps under their laws proscribing gambling and fake exchanges.”2112 About one year later, on December 15, 2000, Congress unanimously passed, without debate, the Commodities Futures

2108 Ibid., 219-220.
2111 The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps, 221.
2112 Ibid. Italic mine.
Modernization Act of 2000 (CMFA). President Clinton quickly signed it into law before his second term came to a close. Senator Gramm announced in a press release shortly after CMFA became a law that it “protects financial institutions from over-regulation... and it guarantees that the United States will maintain its global dominance of financial markets.”

Up until the passing of CMFA, the prevailing opinion was that CDSs were, in fact, securities under the Securities Act of 1933 and the Securities Exchange Act of 1934. As such, there was at least the possibility that the SEC could have regulated various aspects of the budding CDS market if the regulatory agency deemed it necessary to do so. Remarkably, CMFA amended both the Securities Act of 1933 and the Securities Exchange Act of 1934 to henceforth exclude “any security-based swap agreement” from the definition of the term “security” contained in the two acts. CMFA recognized CDSs as “security-based swap agreements,” which meant that they were no longer considered “securities” for the purposes of the Securities Act of 1933 and the Securities Exchange Act of 1934. Subsequently, beyond being subject to antifraud provisions under the two acts, CDSs were from that point on exempt from SEC regulation.

Insofar as CDSs resemble insurance contracts, one may wonder about the extent to which they were subjected to individual state insurance regulations. After all, with respect to the insurance sector, states normally have the authority to issue “licensing

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2113 Nicholas Varchaver and Katie Benner, “The $55 Trillion Dollar Question.”
2115 Ibid.
2116 Ibid., 984-985.
2117 Ibid. Sjostrom, Jr. provides the following working definition of the term “insurance,” taken from Black’s Law Dictionary: “[a] contract by which one party (the insurer) undertakes to indemnify another party (the insured) against risk of loss, damage, or liability arising from the occurrence of some specified contingency.” One would think that this broad definition of insurance would include CDSs. Please see: William K. Sjostrom, Jr., “The AIG Bailout,” 987.
requirements, regulate policy terms, review rates, and conduct financial examinations of insurers.”2118 For any number of reasons, however, CDSs “generally have not been considered insurance for purposes of state insurance regulations and, therefore, have not been subject to these regulations.”2119 In 2004, New York amended its insurance laws to specifically omit CDSs from coverage.2120 Several states followed suit.2121 One of the primary reasons that many states have intentionally avoided including CDSs in their insurance regulations is that those regulations are meant “to protect American consumers.”2122 As William Sjostrom, Jr. explains, “Because the CDS market is comprised entirely of institutional investors, the thinking went that there is no consumer interest with respect to CDSs in need of protection.”2123

Part of the aftermath of these deregulatory measures was that CDS transactions began to take place in a “shadow market,” an over-the-counter market in which CDSs were privately negotiated, went through no exchange, and were completely undocumented.2124 Synchronously, the CDS market grew exponentially, ballooning from a total market value of $100 billion in 2000 to $6.4 trillion in 2004.2125 Despite any positive outcomes that emerged from this prodigious growth, eventually the legal, technological, and paperwork-handling infrastructure could not keep pace with it.2126 In

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2118 Ibid., 987.
2119 Ibid., 988.
2120 Ibid.
2121 Ibid.
2122 Ibid.
2123 Ibid. Italics mine.
2008, then-Chairman of the SEC, Christopher Cox, summarized this development in this way:

The market for CDS is barely 10 years old. It has doubled in size since just two years ago... It has grown between the gaps and seams of the current regulatory system, where neither the commission nor any other government agency can reach it. No one has regulatory authority over credit-default swaps -- not even to require basic reporting or disclosure.\textsuperscript{2127}

Disturbingly, CDS deals began to be routinely and hurriedly completed in one-minute phone conversations\textsuperscript{2128} without the benefit of producing detailed confirmations.\textsuperscript{2129} By September of 2005, the fourteen largest participants in the CDS market had a total of 97,000 CDS trade confirmations that were more than 30 days outstanding.\textsuperscript{2130} David Wessel, writing for The Wall Street Journal at the peak of the housing boom in 2006, affirmed the following about the CDS market: “Record-keeping, documentation and other practices have been so sloppy that no firm could be sure how much risk it was taking or with whom it had a deal. That’s a particularly embarrassing problem for an industry that has resisted regulation of derivatives by arguing that big firms would police each other.”\textsuperscript{2131} One hedge fund manager stated that CDSs had become “essentially the dark matter of the financial universe.”\textsuperscript{2132} In October 2008, Christopher Cox declared, “The regulatory black hole for credit-default swaps is one of the most significant issues we are confronting in the current credit crisis and it requires immediate legislative action.”\textsuperscript{2133} Even former Federal Reserve Chairman and deregulation champion, Alan

\textsuperscript{2127} Robert O’Harrow, Jr. and Brady Dennis, “Downgrades and Downfall,” The Washington Post (December 31, 2008).
\textsuperscript{2128} Nicholas Varchaver and Katie Benner, “The $55 Trillion Dollar Question.”
\textsuperscript{2129} David Wessel, “Wall Street is Cleaning Derivatives Mess.”
\textsuperscript{2130} Ibid.
\textsuperscript{2131} Ibid.
\textsuperscript{2132} Nicholas Varchaver and Katie Benner, “The $55 Trillion Dollar Question.”
\textsuperscript{2133} Robert O’Harrow, Jr. and Brady Dennis, “Downgrades and Downfall.”
Greenspan, conceded during a congressional hearing in October of 2008 that CDSs “have serious problems” and needed to be subjected to stricter oversight. By 2009, no authoritative information about the actual size of the CDS market was even available.

The CDS market not only experienced dramatic growth after the turn of the century, it also became extraordinarily concentrated. By 2007, the ten largest participants accounted for 90% of the market. Throughout the decade, leading up to the subprime crisis, some of the largest CDS counterparties were the five consolidated supervised entities.

4.10. An Additional, Crucial Reason Why Arrangers Were Attracted to CDSs

Based upon this discussion of CDSs, one may be left with the impression that the prodigious growth of this market was exclusively due to the desire of arrangers to customize their risk exposure to subprime MBSs and CDOs. In other words, one may be tempted to conclude that the principal selling point of CDSs, one that spurred the explosive growth of the CDS market leading up to the subprime mortgage crisis, was that they afforded arrangers the opportunity to more efficiently allocate their risk exposure to subprime financial products. While this is certainly one reason why large arrangers aggressively purchased CDSs on their subprime MBSs and CDOs, it is arguably not the chief reason.

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As discussed below, the largest CDS protection seller, by a wide margin, was AIG. By the end of 2007, AIG had sold $527 billion worth of CDSs, an amount which the firm was far from being able to pay out, should the requisite number of credit events occur. In light of this fact, John Carney, writing for *The American Conservative*, raised a penetrating and oft-overlooked question: If one can assume that large, sophisticated arrangers knew that AIG was selling far too much credit protection, why did arrangers continue purchasing CDSs from AIG? If one knew that a certain car insurance company had insured so many automobiles that it would never be able to even come close to compensating its clients should several of them file legitimate insurance claims, why would one ever choose to have that company insure one’s car? Carney argues that many of these arrangers shared AIG’s overly confident outlook on the subprime mortgage market and never seriously believed that they would collect on their CDS contracts.

This consideration, however, merely raises another pertinent question: Why did these same arrangers continue to purchase subprime-related credit protection from AIG, if they were reasonably confident that this protection was, in all likelihood, largely unnecessary? To return to the car insurance analogy, if one earnestly believed that one’s car would never be damaged or stolen, why would one eagerly pay insurance premiums on that car? Carney persuasively argues that many arrangers were attracted to AIG’s CDSs not so much because of the customizable credit protection that those contracts afforded, but instead because CDSs enabled them to hold risky, and potentially

2140 Ibid.
extremely profitable, subprime mortgage assets with lower capital requirements.\textsuperscript{2141} Arnold Kling describes this process as “regulatory capital arbitrage,” one in which arrangers purchased CDSs on risky mortgage products for the sake of being legally permitted to then set aside less capital to shield themselves from possible losses on those assets.\textsuperscript{2142}

To phrase this important point differently, risk-based capital requirements leading up to the subprime mortgage crisis rewarded arrangers for purchasing CDSs on subprime MBSs and CDOs by way of legally freeing up more of their capital to invest in other opportunities, while simultaneously enabling them to reap any of the financial gains yielded by those MBSs and CDOs.\textsuperscript{2143} As John Carney succinctly notes, “Credit default swaps were more like regulatory compliance policies than insurance policies.”\textsuperscript{2144} It is worth pointing out that many arrangers stationed in Europe labeled their CDS purchases as “regulatory capital forbearance” trades.\textsuperscript{2145}

A seminal \textit{Bloomberg Businessweek} article, written in 2008, supports this argument.\textsuperscript{2146} European banks purchased a staggering $426 billion worth of CDSs from AIG in 2007. Ordinarily, those banks were obligated to hold 8\% of the amount of the value of their subprime securities in reserve to protect them against potential declines in the value of those securities. However, by purchasing a CDS on a subprime MBS or

\begin{footnotes}
\footnote{\textsuperscript{2141} Ibid. Please see also: Arnold Kling, “Not What They Had in Mind: A History of Policies that Produced the Financial Crisis of 2008,” \textit{Mercatus Center Papers at George Mason University} (September 2009), available at \url{http://mercatus.org/sites/default/files/publication/NotWhatTheyHadInMind(1).pdf}, 36.}
\footnote{\textsuperscript{2142} Arnold Kling, “Not What They Had in Mind: A History of Policies that Produced the Financial Crisis of 2008,” 36.}
\footnote{\textsuperscript{2143} Ibid.}
\footnote{\textsuperscript{2144} John Carney, “Insuring Disaster: Why Are We Bailing Out AIG -- Again?.”}
\footnote{\textsuperscript{2145} Henny Sender, “AIG Saga Shows Dangers of Credit Default Swaps,” \textit{The Financial Times} (March 6, 2009).}
\footnote{\textsuperscript{2146} David Henry, Matthew Goldstein, and Clare Matlack, “How AIG’s Credit Loophole Squeezed Europe's Banks,” \textit{Bloomberg Businessweek} (October 16, 2008), available at \url{http://www.businessweek.com/magazine/content/08_43/b4105032835044.htm}.}
\end{footnotes}
CDO from AIG, those banks were legally allowed to hold 80% less capital (only 1.6% of the amount of the value of their subprime securities) in reserve on those securities. Purchasing CDSs from AIG, then, freed up more capital for those banks to purchase and securitize more subprime loans. Many regulators around the world eventually adopted this rule.

The key point is that at least part of the strong arranger demand for subprime loans, especially in Europe, was made possible by risk-based capital requirements. By purchasing CDSs on subprime MBSs and CDOs from AIG, arrangers were relieved from much of the capital reserve burden that those requirements would have otherwise imposed on them. With subsequently more capital at their disposal, arrangers could invest more heavily in the subprime mortgage market. As John Carney observes, “Basically, banking regulations encouraged companies to buy cheap swaps so that they could treat risky investments as almost risk-free. This, in turn, allowed them to take money out of their reserves and buy more risky assets, which they then covered up with more credit default swaps.”

Eric Dinallo, former superintendent of the New York State Insurance Department, nicely summarized the matter by affirming, “[A]n essentially unregulated institution, AIG Financial Products, sold unregulated securities, credit default swaps, which were used to help regulated banks evade regulation and hold less capital in reserve than necessary.” It is now necessary to examine in more detail AIG’s relationship with

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2147 Ibid.
2148 All the Devils are Here: The Hidden History of the Financial Crisis, 81.
the arrangers as well as how the insurance titan contributed to the subprime mortgage crisis.

4.11. The Dramatic Collapse of AIG

American International Group, Inc. (AIG), with its Shanghai-based roots stretching back to 1919,\(^{2151}\) is “a holding company which, through its subsidiaries, is engaged in a broad range of insurance and insurance-related activities in the United States and abroad.”\(^{2152}\) The company is incorporated in Delaware, and its common stock is listed on the New York Stock Exchange.\(^{2153}\) AIG has operations “in more than 130 countries with about half of its revenues derived from its foreign operations.”\(^{2154}\) These operations include underwriting “commercial property, casualty, workers’ compensation, and mortgage guarantee insurance,” activities that take place in its General Insurance unit.\(^{2155}\) AIG also provides “individual and group life, payout annuities, endowment, and accident and health insurance policies” through its Life Insurance and Retirement Service unit.\(^{2156}\) Furthermore, AIG offers “a wide variety of investment-related services and investment products to individuals, pension funds, and institutions” through its Asset Management unit.\(^{2157}\) Finally, through its Financial Services unit, AIG “engages in aircraft equipment leasing, capital market transactions (including CDS transactions),


\(^{2153}\) Ibid.

\(^{2154}\) Ibid.

\(^{2155}\) Ibid., 946.

\(^{2156}\) Ibid.

\(^{2157}\) Ibid.
consumer finance, and insurance premium finance." 2158 A Wall Street Journal article touched upon the singularity and diversity of AIG’s operations, colorfully citing how the company “sells annuities to teachers in West Virginia, liability insurance to the biggest American corporations, workers’ compensation coverage to restaurants and policies covering cows in dusty Jhalawar, India.” 2159

At the end of December of 2007, AIG had assets totaling $1.06 trillion. 2160 The company ranked tenth in the 2007 Fortune 500 and twenty-third in the 2007 Global 500. 2161 Before its collapse, AIG had over 116,000 employees. 2162 As an article in The Wall Street Journal noted, “AIG’s size and complexity meant that its tentacles were spread throughout the financial system,” which made it “almost impossible to be certain about the impact of a collapse -- other than to know it was potentially catastrophic.” 2163 The seeds of AIG’s collapse, which were predominately sown by its Financial Services unit, will now be explored.

AIG Financial Products Corporation, AIG Trading Group, and their respective subsidiaries (collectively, AIGFP) are all parts of AIG’s Financial Services unit. AIGFP, which had major operations in London, was founded in 1987 and handled AIG’s CDS business. In 1998, JPMorgan Chase approached AIGFP and suggested that it should try to write insurance on tranches of its CDOs. 2164 The Chief Financial Officer of AIGFP at the time, Joseph Cassano, looked back on this invitation and claimed that it was “a

2158 Ibid.
2159 Monica Langley, Deborah Solomon and Matthew Karnitschnig, “Bad Bets and Cash Crunch Pushed Ailing AIG to Brink.”
2160 Ibid.
2161 Ibid.
2163 Monica Langley, Deborah Solomon, and Matthew Karnitschnig, “Bad Bets and Cash Crunch Pushed Ailing AIG to Brink.”
2164 Gretchen Morgenson, “Behind Insurer’s Crisis, Blind Eye to a Web of Risk.”
watershed event” for the unit.\textsuperscript{2165} That same year, AIGFP wrote its first CDS. At this time, the tranches of CDOs for which AIGFP offered credit protection were typically composed of highly rated corporate bonds and a small minority of MBSs.\textsuperscript{2166}

One should note that AIG “contractually guarantees ‘all present and future payment obligations and liabilities of AIGFP arising from transactions entered into by AIGFP.’”\textsuperscript{2167} Before AIG’s fall, the company’s guarantees provided AIGFP with a profound competitive advantage over many of the credit protection sellers in the CDS market.\textsuperscript{2168} AIG’s sterling triple-A credit rating instilled confidence in many protection buyers that AIGFP’s CDS contracts would be honored should a credit event occur. To phrase this point differently, from the perception of credit protection buyers, AIG’s triple-A rating enhanced the quality of AIGFP’s credit protection.\textsuperscript{2169} Presumably, other things being equal, protection buyers were willing to pay AIGFP more for their credit protection than they would from a competitor that was offering the same protection, but backed by a parent company with a lower credit rating.\textsuperscript{2170}

AIG’s triple-A rating made AIGFP’s CDS business attractive for another reason aside from serving as a magnet for protection buyers: AIGFP was initially relieved from having to post collateral on its CDSs by its protection buyer counterparties.\textsuperscript{2171} Ordinarily, a protection buyer requires a protection seller to post collateral “equal to a

\begin{thebibliography}{99}
\item[2166] Ibid.
\item[2168] Robert O'Harrow Jr. and Brady Dennis, “Downgrades and Downfall.”
\item[2170] Ibid. See also: Antuilio N. Bomfim, \textit{Understanding Credit Derivatives and Related Instruments} (San Diego: Elsevier Academic Press, 2005), 10.
\item[2171] Gretchen Morgenson, “Behind Insurer’s Crisis, Blind Eye to a Web of Risk.”
\end{thebibliography}
specified percentage of the notional amount of the CDS."\textsuperscript{2172} The required collateral posting, typically made in cash, is a way in which a protection buyer can address the counterparty credit risk that accompanies a CDS contract: the risk that “a protection seller will be unable or unwilling to make the payment due under a CDS following a credit event.”\textsuperscript{2173} The higher a protection seller’s credit rating, the lower the collateral percentage a protection buyer usually demands because a higher credit rating signals a lower probability of protection seller default.\textsuperscript{2174} All the way up until September of 2007, AIGFP did not post any collateral on its CDSs, due in large part to the triple-A rating of AIG.\textsuperscript{2175} 

Negligible initial collateral posting requirements on their CDSs made this line of business all the more profitable for AIGFP.\textsuperscript{2176} Whereas AIGFP had $737 million in revenue in 1999, it generated over $3.26 billion in revenue by 2005, an increase of over 340%.\textsuperscript{2177} This growth was accompanied by increasingly enviable profit margins. In 2002, AIGFP’s operating income was 44% of its revenue, a number that rose to 83% by 2005.\textsuperscript{2178} On June 1, 2007, AIG enjoyed its highest stock price of $72.65 per share.\textsuperscript{2179} 

AIGFP’s profitability was made possible by computer models developed by Gary Gorton, a professor at Yale University’s School of Management. Gorton collected vast amounts of historical loan performance data and then built models that were designed to

\begin{itemize}
\item \textsuperscript{2172} William K. Sjostrom, Jr., “The AIG Bailout,” 950-951.
\item \textsuperscript{2173} Ibid., 950.
\item \textsuperscript{2174} Ibid., 951.
\item \textsuperscript{2176} Gretchen Morgenson, “Behind Insurer’s Crisis, Blind Eye to a Web of Risk.”
\item \textsuperscript{2177} Ibid.
\item \textsuperscript{2178} Ibid.
\item \textsuperscript{2179} The Financial Crisis of Our Time, 120.
\end{itemize}
forecast losses on tranches of CDOs.\textsuperscript{2180} These CDOs were extraordinarily complex, some of them involving “more than 100 securities, each backed by multiple mortgages, auto loans or credit-card receivables.”\textsuperscript{2181} CDOs of this variety were named \textit{multi-sector CDOs},\textsuperscript{2182} and they were the primary vehicle through which AIGFP exposed itself to the subprime mortgage market.\textsuperscript{2183}

The disparate nature and daunting number of the loans made it difficult to value and assess the credit risk of these CDOs.\textsuperscript{2184} Gorton’s models were intended to assess the amount of credit risk that particular CDO tranches contained, specifically the safest, super-senior tranches.\textsuperscript{2185} Armed with this knowledge, AIGFP believed that it could prudently enter into CDS contracts with counterparties that wanted to purchase credit risk protection on various tranches of CDOs. These counterparties included “banks and investment banks, pension funds, endowments, foundations, insurance companies, hedge funds, money managers, high-net-worth individuals, municipalities and sovereigns and supranationals.”\textsuperscript{2186}

AIGFP’s top officials became so confident in the models’ ability to assess credit risk that they eventually claimed that their CDS deals would generate millions of dollars in fees “for taking on infinitesimal risk.”\textsuperscript{2187} In 2007, AIGFP’s Chief Financial Officer, Joseph Cassano, memorably stated about the unit’s CDS deals, “It is hard for us, without

\begin{itemize}
\item Carrick Mollenkamp, Serena Ng, Liam Pleven, and Randall Smith, “Behind AIG's Fall, Risk Models Failed to Pass Real-World Test,” \textit{The Wall Street Journal} (October 31, 2008).
\item Ibid.
\item William K. Sjostrom, Jr., “The AIG Bailout,” 959.
\item Robert O'Harrow Jr. and Brady Dennis, “Downgrades and Downfall.”
\item Carrick Mollenkamp, Serena Ng, Liam Pleven, and Randall Smith, “Behind AIG's Fall, Risk Models Failed to Pass Real-World Test.”
\item Robert O'Harrow Jr. and Brady Dennis, “Downgrades and Downfall.”
\item Ibid., “A Crack in the System.”
\end{itemize}
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.”  

2188 Michael Lewis noted that the people working at AIGFP felt that Cassano was “a guy with a crude feel for financial risk but a real talent for bullying people who doubted him.”  

2189 AIGFP’s Chief Executive Officer, Tom Savage, agreed with Cassano, however, and declared, “The models suggested that the risk was so remote that the fees were almost free money.”  

2190 Reinforcing this confidence was the fact that AIGFP’s CDSs were mainly written on super senior CDO tranches, which provided an innate “credit event buffer,” since the holders of the lower, mezzanine tranches would suffer the first losses should a requisite number of loans backing the CDO go into default.  

2191 Gorton’s models supposedly revealed that, for certain CDS deals, there was a 99.85% chance that AIGFP would not have to pay out a single dollar to its protection buyers.  

2192 AIG’s and, hence, AIGFP’s chief regulator was the OTS, who was similarly dazzled by the high credit ratings of the underlying tranches of CDOs, claiming that they helped make AIGFP’s CDSs “fairly benign products.”  

2193 By the end of December of 2007, AIGFP had sold approximately $527 billion worth of CDSs, $78 billion of which provided credit protection on tranches of multi-
sector CDOs.\textsuperscript{2194} Of that $78 billion worth of multi-sector CDO credit protection, roughly $61.4 billion were directly backed by subprime mortgages.\textsuperscript{2195} In hindsight, it is remarkable that since CDSs were virtually unregulated and not categorized as traditional insurance products, AIG did not have to set aside any money for potential losses on the subprime MBSs and CDOs that it was insuring. Joe Nocera likens this absurd situation to an insurance company recklessly insuring against earthquakes and not being legally required to put money away in reserve in case an actual earthquake occurs.\textsuperscript{2196}

One of the most striking aspects of AIG’s decline is that AIGFP recognized the dangers of their subprime exposure as early as the beginning part of 2004.\textsuperscript{2197} By the end of 2005, before the peak of the subprime mortgage boom in 2006, AIGFP decided to cease writing CDSs on tranches of CDOs backed by subprime mortgages altogether.\textsuperscript{2198} Nevertheless, AIGFP’s subprime exposure through its CDSs proved to be fatal to AIG, so much so that it caused the parent company, which had $1 trillion worth of assets, to run out of cash.\textsuperscript{2199} I will now briefly examine the events leading up to, as well as the primary causes of, the collapse of AIG, one that Michael Lewis noted was “perhaps the most sensational corporate collapse in the history of finance.”\textsuperscript{2200}

Importantly, regardless of how well Gorton’s models measured the credit risk accompanying various tranches of CDOs, those same models \textit{did not} assess at least two

\textsuperscript{2194} William K. Sjostrom, Jr., “The AIG Bailout,” 955.
\textsuperscript{2195} Ibid., 959.
\textsuperscript{2197} Robert O'Harrow Jr. and Brady Dennis, “Downgrades and Downfall.” According to Michael Lewis, however, AIGFP was oblivious to the amount of credit protection they were selling on subprime-related securities – let alone to the risks posed by those securities – as late as the end of 2005. As one former AIGFP trader put it, “None of [AIGFP’s employees] knew… Which sounds incredible. But an entire financial system was premised on their not knowing – and paying them for their talent!” Please see: Michael Lewis, “The Man Who Crashed the World,” 138.
\textsuperscript{2198} Ibid.
\textsuperscript{2199} William K. Sjostrom, Jr., “The AIG Bailout,” 959.
other pertinent risks: the risk that AIG’s credit rating would be downgraded, and the risk that the tranches themselves would decline in value. AIG was aware of both of those omissions.\textsuperscript{2201} Still, as AIGFP was writing CDSs on tranches of CDOs backed by subprime mortgages in the early 2000’s, both of those risks most likely appeared to be remote.\textsuperscript{2202}

A harbinger of AIG’s collapse occurred as early as March of 2005 when the three major NRSROs downgraded the company’s credit rating from AAA (Aaa) to AA+ (Aa+).\textsuperscript{2203} Due to provisions contained in AIGFP’s CDS contracts, AIG was required to post $1.16 billion in collateral to compensate protection buyers for the hit to its creditworthiness.\textsuperscript{2204} AIGFP managed to churn out $4.424 billion in profits that year even with its parent company’s recently tarnished credit rating.\textsuperscript{2205} In 2006, AIGFP’s profitability sharply diminished, recording just $383 million in profits.\textsuperscript{2206}

In the summer of 2007, when the United States residential mortgage market in general, and the subprime mortgage market in particular, declined, the three major NRSROs began downgrading the ratings of many multi-sector CDOs. The ratings downgrades caused those CDOs to lose value. As explained by William K. Sjostrom, Jr., “The large majority of AIGFP’s multi-sector CDO CDSs base[d] collateral posting requirements on the difference between the notional amount of the particular CDS and the market value of the underlying CDO security. Accordingly, as CDO values tanked,

\textsuperscript{2201} Carrick Mollenkamp, Serena Ng, Liam Pleven and Randall Smith, “Behind AIG’s Fall, Risk Models Failed to Pass Real-World Test.”
\textsuperscript{2202} William K. Sjostrom, Jr., “The AIG Bailout,” 957.
\textsuperscript{2203} Robert O’Harrow Jr. and Brady Dennis, “Downgrades and Downfall.”
\textsuperscript{2204} Ibid.
\textsuperscript{2205} William K. Sjostrom, Jr., “The AIG Bailout,” 947.
AIG was obligated to post more and more cash collateral." 2207 AIG was suddenly confronted by a tidal wave of protection buyer collateral calls, most seriously a $1.5 billion collateral posting demanded by Goldman Sachs in October of 2007. 2208

Approximately three years later, the chairman of the Financial Crisis Inquiry Commission, Phil Angelides, asked Goldman Sach’s CFO, David Viniar, about the criteria that arranger used to determine the amount of its collateral calls. Viniar responded, “For illiquid assets, it’s not a science, it’s an art, and there is judgment involved. We used our best estimate at all times of what the market was.” 2209 An AIG executive later conceded that it “didn’t have an internal pricing system at that time” to dispute Goldman Sach’s estimates. 2210

The collateral calls and the turbulence in the residential mortgage market caused AIG’s stock price to tumble. In six weeks, from October to mid-November of 2007, AIG’s stock price plummeted 25%. 2211 Compounding these difficulties, AIG’s auditor, PricewaterhouseCoopers, informed the company that it “could have a material weakness” in its risk management. 2212 The auditor further stated that they could not decipher whether the value that AIGFP placed on its CDS portfolio was accurate. 2213 Despite these portents, AIG’s Chief Executive Officer at the time, Martin Sullivan, reassured investors in a December 2007 webcast that its CDS business was “carefully underwritten” and the probability that that the business would sustain a loss was “close to zero.” 2214 About two

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2208 Robert O’Harrow Jr. and Brady Dennis, “Downgrades and Downfall.”
2210 Ibid.
2211 Ibid.
2212 Ibid.
2213 Ibid.
2214 Ibid.
months later, on February 28, 2008, AIG announced that while AIGFP’s CDS portfolio had recently suffered an estimated $11.5 billion loss and that the company had posted $5.3 billion in collateral, the company as a whole made $6.2 billion in 2007. AIG’s stock closed that day at $50.15 per share.

Over the first eight months of 2008, AIG’s CDS portfolio sustained another $19.9 billion in losses. In just two months, between July 1, 2008 and August 31, 2008, protection buyers of AIGFP’s CDSs impelled AIG to post an additional $6.0 billion in collateral, representing a whopping 34% of the cash and cash equivalents that the company had available at the beginning of July. By the early part of September of 2008, with their losses mounting and the residential real estate market steadily dropping, AIG was virtually unable to borrow money from the capital markets.

The critical moment of AIG’s collapse came on September 15, 2008 when the three largest NRSRO’s further downgraded AIG’s credit rating. Instantly, AIG was contractually obligated to post over $20 billion in collateral to compensate its CDS protection buyers. Unable to meet the collateral calls, the next day AIG met with representatives from Goldman Sachs, JPMorgan, and the Federal Reserve Bank of New York to put together “a $75 billion secured lending facility syndicated among various financial institutions.” As the day progressed, it became increasingly apparent that a private sector lending agreement would not be reached. Later that same evening, the

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2215 Ibid.
2217 Ibid.
2218 Ibid., 960.
2219 Ibid., 960-961.
2220 Ibid., 962.
2221 Ibid.
2222 Ibid., 963.
2223 Ibid.
Fed announced, with the full support of the United States Treasury Department, that it “had authorized the NY Fed to bail out AIG through an $85 billion revolving credit facility.”

Congressman Barney Frank reportedly asked the Chairman of the Fed, Ben Bernanke, “if he had $85 billion to bestow in this way,” to which Bernanke memorably replied, “I have $800 billion.” For the first time in American history, the Fed opened the discount window to an insurance company.

According to a Fed press release that was issued on September 16, 2008, the legal authority for the bailout was derived from section 13(3) of the Federal Reserve Act, which permitted the Fed to lend money to non-depository institutions in “unusual and exigent circumstances.” The Fed determined that “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,” thus warranting the emergency loan. As Kathleen Engel and Patricia McCoy explain, “If AIG failed and reneged on its swaps, institutions that had bought default protection on the bonds they held would be forced to take write-downs, eroding their capital and forcing them to raise more equity just when the stock markets were in disarray.” Another reason cited for the bailout was that AIG’s stock was one of the ten most widely held stocks in 401(k) retirement plans. The failure of the venerable investment bank, Lehman Brothers, on the previous day was the largest bankruptcy filing

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2224 Ibid.
2226 The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps, 106.
2228 The Federal Reserve Board, “Press Release.”
2229 The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps, 105.
in United States history, which heightened the perception that AIG urgently needed to be rescued.\footnote{The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps, 105.} On September 17, 2008, AIG’s share price fell to $2.05 per share, a decline of 97.1\% from its June 1, 2007 high of $72.65 per share.\footnote{The Financial Crisis of Our Time, 123.}

Just three weeks later, by October 8, 2008, AIG had already borrowed $61 billion of its available $85 billion line of credit. On that day, the Fed lent another $37.8 billion to the ailing insurance company.\footnote{The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps, 105} It also surfaced on that day that, less than a week after AIG received its initial bailout, seventy of AIG’s top performers were rewarded with a week-long stay at the luxury St. Regis Resort in Monarch Beach, California, where they ran up a tab of $440,000.\footnote{Peter Whoriskey, “AIG Spa Trip Fuels Fury on the Hill,” The Washington Post (October 8, 2008).} Andrew Cuomo, the attorney general at the time, wrote a caustic letter to AIG’s board of directors that cited recent “unwarranted and outrageous expenditures,”\footnote{Jonathan D. Glater and Vikas Bajaj, “Cuomo Seeks Recovery of Bonuses at A.I.G.,” The New York Times (October 15, 2008), available at http://www.nytimes.com/2008/10/16/business/16pay.html.} which included an $86,000 partridge-hunting trip in the English countryside.\footnote{Andrew Ross Sorkin, Too Big to Fail (New York: Penguin, 2009), 532.}

Three weeks after this second loan, on October 30, 2008, the Fed permitted AIG to borrow another $20.9 billion. The next month, the United States Treasury Department restructured AIG’s bailout package and the total aid to the company ballooned to $150 billion. In March of 2009, just before AIG announced a \textit{quarterly} loss of a breathtaking $61.7 billion, the company received another cash injection of $30 billion.\footnote{The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps, 105} It was the largest quarterly loss in United States corporate history.\footnote{William K. Sjostrom, Jr., “The AIG Bailout,” 972.} AIG ultimately posted an

On March 15, 2009, AIG revealed that approximately $120 billion of its bailout money had been paid out to domestic and international trading partners, mostly investment banks and municipalities.\footnote{Michael Simkovic, “Secret Liens and the Financial Crisis of 2008,” \textit{American Bankruptcy Law Journal}, Vol. 83, No. 2 (Spring 2009), 284.} Three of the largest recipients of the bailout money were Goldman Sachs ($13 billion), Société Générale SA ($12 billion), and Deutsche Bank ($12 billion). The disclosure elicited public outcry due to the fact that taxpayer funds were being used to make whole private businesses and international banks. It also simultaneously came to light that AIGFP employees received $450 million in bonuses in 2008.\footnote{Liam Pleven, Serena Ng, and Sudeep Reddy, “AIG Faces Growing Wrath Over Payouts,” \textit{The Wall Street Journal} (March 16, 2009).}

Then-director of the White House National Economic Council, Lawrence Summers, noted that while there were many troubling aspects of the financial crisis, what had happened at AIG was “the most outrageous.”\footnote{Ibid.} Chairman of the Fed, Ben Bernanke, stated that nothing had made him angrier since the outbreak of the financial crisis than AIG’s conduct. He proclaimed that the insurance company “made irresponsible bets” and “exploited a huge gap in the regulatory system.”\footnote{David Stout and Brian Knowlton, “Fed Chief Says Insurance Giant Acted Irresponsibly,” \textit{The New York Times} (March 3, 2009), available at http://www.nytimes.com/2009/03/03/business/worldbusiness/03iht-03webecon.20567563.html.}

Nearly a year after this disclosure, the United States House of Representatives’ Committee on Oversight and Reform uncovered the fact that the Fed instructed AIG to
withhold the names of its CDS counterparties during the initial stages of the bailout.2244 The committee also discovered that part of the bailout agreement required AIG to forfeit its right to sue several of its CDS counterparties, including Goldman Sachs and Merrill Lynch, over any irregularities with any of the reference obligations for which it had sold credit protection.2245 Furthermore, the committee learned that the Fed ignored recommendations from their own advisors that it should force AIG’s counterparties to accept losses on their deals with AIG. Instead, the Fed opted to award AIG’s counterparties “100 cents on the dollar to unwind [the] debt insurance” that they had bought from the insurer.2246

The committee held an emotional hearing on January 27, 2010 to discuss its findings and the bailout of AIG. The chairman of the committee, Congressman Edolphus Towns, opened the hearing by affirming:

In effect, the taxpayers were propping up the hollow shell of AIG by stuffing it with money, and the rest of Wall Street came by and looted the corpse… [W]e can talk all we want to about complicated business deals, but this all boils down to a simple concept: when average people were losing their homes and jobs, the same big banks that caused the problems got every dollar back, courtesy of the American taxpayer. And the Federal Reserve tried to keep important information a secret.”2247

John Carney, writing for The American Conservative, labeled AIG “perhaps the most efficient [wealth] redistribution machine ever built.”2248

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2246 Ibid.
2248 John Carney, “Insuring Disaster: Why Are We Bailing Out AIG -- Again?”
All told, AIG received $182.4 billion in aid from the Fed and the Treasury Department: $89.5 billion in loans from the Fed, $49.1 billion in loans from the Treasury Department through the Troubled Asset Relief Program, and an additional $43.8 billion in loans from the Fed to capitalize two SPVs, Maiden Lane II and Maiden Lane III, which were created for the sake of housing CDOs that were initially purchased by AIG’s CDS counterparties.\footnote{Congressional Oversight Panel, March Oversight Report: The Final Report of the Congressional Oversight Panel (March 16, 2010), available at http://www.gpo.gov/fdsys/pkg/CHRG-112shrg64832/pdf/CHRG-112shrg64832.pdf, 109. The $43.8 billion in loans were expressly designed to alleviate AIG’s capital and liquidity pressures by canceling the company’s CDS contracts, which were requiring the insurance company to post collateral. The Fed then bought the CDOs at par from several of AIG’s CDS counterparties. For example, Maiden Lane II contains a $156 million piece of the now-bankrupt New Century’s Home Equity Loan Trust 2005-3. Approximately 40% of the loans in this trust were NINA loans that were originated by New Century. Please see: Serena Ng and Carrick Mollenkamp, “New York Fed Caved In to AIG Creditors,” The Wall Street Journal (November 17, 2009); Carrick Mollenkamp, Lingling Wei, and Serena Ng, “Mortgage Problems? Fed Can Relate,” The Wall Street Journal (April 2, 2010). Adding to the complexity of this endeavor was the fact that, in some cases, the protection buyers that demanded collateral from AIG did not actually own the securities for which they bought protection. Rather, they bought credit protection from AIG on securities that they had merely speculated on, which made the bailout all the more problematic and resistant to efficacious solutions. Please see: Serena Ng, Carrick Mollenkamp, and Michael Siconolfi, “AIG Faces $10 Billion in Losses on Bad Bets,” The Wall Street Journal (December 10, 2008).} In the middle part of 2009, shares of AIG’s stock were trading at less than $1.00 per share,\footnote{William K. Sjostrom, Jr., “The AIG Bailout,” 945. On May 30, 2009, there was a 20:1 reverse split of AIG’s shares.} and the company ended up posting a $10.9 billion loss that year.\footnote{Serena Ng and Joe Bel Bruno, “AIG ‘Not Out of the Woods’,” The Wall Street Journal (February 27, 2010).} AIG’s losing streak continued into 2010, with the company posting a yearly loss of $898 million.\footnote{Serena Ng and Erik Holm, “At AIG Silence is Now Golden,” The Wall Street Journal (February 26, 2011). This figure excludes divestures and restructuring-related gains and losses.}

In June of 2011, AIG completed a wind-down of AIGFP’s operations,\footnote{Serena Ng, “AIG Profits in Wind-Down,” The Wall Street Journal (August 6, 2011).} and on August 4, 2011, the insurance company announced a second quarter profit of $1.8 billion.\footnote{Tom Braithwaite, “‘Crisis Over for AIG,’ Says Chief,” The Financial Times (August 5, 2011).} AIG’s Chief Executive Officer, Robert Benmosche, declared in the wake of
the earnings announcement, “Our crisis is over. It’s done.” AIG also recently revealed that it is planning to sue Bank of America over a material misrepresentation of hundreds of mortgage-backed securities, which caused the insurance company sustain billions of dollars in losses. As of March 22, 2012, AIG still owes the Fed $9 billion and the Treasury Department $35.7 billion.

Thus far, I have explored the fates of three of the key subprime arrangers (Lehman Brothers, Merrill Lynch, and Bear Stearns). Furthermore, I examined the relationship between AIG and subprime arrangers, noting how the former, for a fee, abetted the latter to imprudently securitize massive amounts of subprime MBSs and CDOs. I will now conclude this section by discussing how the last two arrangers standing on their own contributed to the subprime crisis. Those two arrangers are the most prestigious of them all: Goldman Sachs and Morgan Stanley.

4.12. A Brief Examination of How Goldman Sachs Contributed to the Subprime Mortgage Crisis

Goldman Sachs, established in 1869 as an investment bank, was another arranger that had a significant presence in the subprime mortgage market leading up to the crisis. While its residential mortgage business began in 1984, Goldman Sachs did not heavily enter into the subprime mortgage market until 2002, when it issued $4.314 billion worth

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2255 Ibid.
2258 Jon Hilsenrath, Damian Paletta, and Aaron Lucchetti, “Goldman, Morgan Scrap Wall Street Model, Become Banks in Bid to Ride Out Crisis.”
of subprime securities that year.\textsuperscript{2259} By that time, Goldman Sachs had acquired a subprime lender of its own, Southern Pacific Funding Corporation.\textsuperscript{2260} One publication estimated that Goldman securitized $2.538 billion, $9.506 billion, $11.307 billion, $13.166 billion, and $6.802 billion worth of subprime MBSs in 2003, 2004, 2005, 2006, and 2007 respectively.\textsuperscript{2261}

According to The Financial Crisis Inquiry Report, Goldman Sachs acquired $53 billion worth of mortgage loans from subprime lenders between 2004 and 2006.\textsuperscript{2262} The report calls attention to how, on one hand, the arranger provided billions of dollars to subprime lenders over that period of time, the majority of which went to Ameriquest, New Century, Countrywide, and Long Beach Mortgage Company, in order to fund the risky mortgages that those lenders were originating for borrowers.\textsuperscript{2263} On the other hand, the report also accuses Goldman Sachs of securitizing and selling those loans to investors, effectively pushing those risky mortgages into the financial system. The report additionally claims that during this period of time, Goldman Sachs issued $32 billion worth of CDOs.\textsuperscript{2264} Fannie Mae, Freddie Mac,\textsuperscript{2265} pension plans, and insurance

\textsuperscript{2259} Compass Point Research \& Trading LLC, \textit{Mortgage Finance: Mortgage Repurchases Part II: Private Label RMBS Investors Take Aim – Quantifying the Risks} (August 17, 2010), 8.
\textsuperscript{2261} Compass Point Research \& Trading LLC, \textit{Mortgage Finance: Mortgage Repurchases Part II: Private Label RMBS Investors Take Aim – Quantifying the Risks}, 8.
\textsuperscript{2263} Ibid.
\textsuperscript{2264} Ibid.
companies were some of the largest investors in these Goldman Sachs-issued subprime MBSs and CDOs.

Recent probes into Goldman Sachs’ conduct as an arranger of subprime mortgage deals have revealed that the firm categorically knew that the MBSs and CDOs they were creating for investors were not as safe as their offering materials and, indeed, the credit ratings of those securities indicated. As a September 2011 lawsuit filed by the FHFA against Goldman Sachs disclosed, the arranger knew as early as 2005 that the subprime market was headed for disaster. The lawsuit notes that Goldman Sachs’ “sophisticated and powerful proprietary models analyzed trends in the performance of the hundreds of thousands of mortgages” that backed the subprime MBSs that the arranger was issuing. Crucially, Goldman Sachs’ models revealed that their subprime MBSs had declined up to 70% of their face amounts. One former Goldman Sachs employee stated that their models and the information that the arranger had in its exclusive possession showed that “the writing was on the wall in this market as early as 2005.” In a now-infamous e-mail, one Goldman Sachs executive, Fabrice Tourre wrote about the United States housing market in January of 2007, “More and more leverage in the system. The whole building is about to collapse anytime now... Only potential survivor, the fabulous Fabrice Tourre]... standing in the middle of all these complex, highly

2269 Ibid.
2270 Ibid.
2271 Ibid. Please also see: Gretchen Morgenson and Louise Story, “Banks Bundled Debt, Bet Against It and Won.”
leveraged, exotic trades he created without necessarily understanding all of the
implication of those monstruosities [sic]!!”2272 I will now briefly describe some of the
decisions that Goldman Sachs elected to make once they had this information at their
disposal.

First, Goldman Sachs continued to offer warehouse lines of credit to subprime
mortgage lenders in order to purchase mortgages to bundle into MBSs and CDOs. However, it used its superior knowledge of the risk that those mortgages contained not to
increasingly filter out fraudulent or questionable loans, but instead to negotiate a better,
lower price for itself.2273 As the FHFA lawsuit against Goldman Sachs states, “[R]ather
than reject defective loans from collateral pools, or cease doing business with
consistently failing originators,” Goldman Sachs elected instead to use its data to simply
“insist on a lower price from the loan originators, leaving more room for its own profits
while the defective loans were hidden from investors such as Fannie Mae and Freddie
Mac in securitization pools.”2274 The lawsuit underscores that, internally, Goldman Sachs
referred to its own subprime MBSs and CDOs that it was offering to investors as “junk,”
“dogs,” and “monstrosities.”2275

Second, using their unique access to the quality and direction of the subprime
mortgage market, Goldman Sachs aggressively attempted to offload its existing inventory
of subprime MBSs and CDOs onto investors. In an April 2011 report issued by the
United States Senate Permanent Subcommittee on Investigations, Goldman Sachs was

2274 Ibid., 73-74.
2275 Ibid., 75.
accused of knowingly selling “high risk, poor quality mortgage products to clients around the world, saturating financial markets with complex, financially engineered instruments that magnified risk and losses when their underlying assets began to fail.”\textsuperscript{2276} One particularly striking quote came from the former head of Goldman Sachs’ mortgage department, Daniel Sparks, who celebrated in January of 2007 that his team had “structured like mad and traveled the world, and worked their tails off to make some lemonade from some big old lemons.”\textsuperscript{2277}

The same report cites how Goldman Sachs’ senior management “knew its sales force was selling CDO securities at inflated prices and that the CDO securities were rapidly losing value.”\textsuperscript{2278} Astonishingly, Goldman Sachs would also mark down the value of its issued CDOs once they were sold, causing some of their customers “to incur substantial losses within days or weeks of a purchase.”\textsuperscript{2279} For instance, one Goldman Sachs salesperson regretted a recent sale of a CDO to a client by declaring, “Real bad feeling across European sales about some of the trades we did with clients. The damage this has done to our franchise is significant. Aggregate loss for our clients on just 5 trades alone is 1bln+.”\textsuperscript{2280}

In less than a year, from November 24, 2006 to August 31, 2007, Goldman Sachs greatly reduced its exposure to subprime loans and MBSs. Whereas the arranger had a subprime loan inventory worth $7.8 billion on November 24, 2006, the value of that

\textsuperscript{2277} Quinn Emanuel Urquhart & Sullivan, LLP, “United States District Court, Southern District of New York: Federal Housing Finance Agency Complaint Against Goldman, Sachs & Co.,” 75.
\textsuperscript{2279} Ibid., 507-508.
\textsuperscript{2280} Ibid., 508.
inventory was reduced by over 94% to $462 million by August 31, 2007.\textsuperscript{2281} In terms of subprime MBSs, over of the same period, Goldman Sachs had an inventory worth $7.2 billion, which was eventually reduced by over 66% to $2.7 billion.\textsuperscript{2282} Goldman Sachs also frantically attempted to offload its subprime CDOs throughout 2007 by expanding its selling efforts to “nontraditional buyers” of the financial product as well as to “banks, hedge funds, and other clients in Asia, Europe, and the Middle East.”\textsuperscript{2283} The arranger also “issued directives to its sales force to sell specific CDO securities on a ‘first priority’ basis,” offering them attractive incentives to push the sales through.\textsuperscript{2284}

Third, and perhaps most egregiously, Goldman Sachs used its superior knowledge of the subprime mortgage market to place bets that it would collapse, while continuing to market and sell their subprime MBSs and CDOs as though they were desirable investments. The arranger also purchased approximately $33 billion worth of CDS protection from AIG, which ultimately shielded it from having to absorb losses on assets worth $22 billion.\textsuperscript{2285} The April 2011 report issued by the United States Senate Permanent Subcommittee on Investigations provided an excellent example of this strategy.

In March of 2007, Goldman Sachs securitized over $1 billion worth of subprime loans that it had purchased from the notorious subprime lender, Freemont Loan & Investment. The securitization created GSAMP Trust 2007-FM2.\textsuperscript{2286} The arranger marketed and eventually sold the securitization to Freddie Mac and then purchased CDSs

\begin{itemize}
\item \textsuperscript{2281} Ibid., 489.
\item \textsuperscript{2282} Ibid., 489-490.
\item \textsuperscript{2283} Ibid., 503.
\item \textsuperscript{2284} Ibid.
\item \textsuperscript{2285} Serena Ng and Carrick Mollenkamp, “Goldman Fueled AIG Gambles --- Wall Street Firm's Role Shown in Journal Analysis; It Says Problems Hidden,” \textit{The Wall Street Journal} (December 12, 2009).
\item \textsuperscript{2286} United States Senate Permanent Subcommittee on Investigations, \textit{Wall Street and the Financial Crisis: Anatomy of a Financial Collapse}, 515-516.
\end{itemize}
worth $15 million, which amounted to a wager that the securitization would decline in value. By August of 2009, every single tranche in the securitization had been downgraded to junk status. About this strategy, one expert in structured finance remarked, “The simultaneous selling of securities to customers and shorting them because they believed they were going to default is the most cynical use of credit information that I have ever seen… When you buy protection against an event that you have a hand in causing, you are buying fire insurance on someone else’s house and then committing arson.”

Another writer observed, “Goldman was like a car dealership that realized it had a whole lot full of cars with faulty brakes. Instead of announcing a recall, it surged ahead with a two-fold plan to make a fortune: first, by dumping the dangerous products on other people, and second, by taking out life insurance against the fools who bought the deadly cars.”

As the subprime mortgage crisis began to unfold, a conflict of interest between Goldman Sachs’ proprietary trading and market making responsibilities emerged. Louise Story, writing for The New York Times, provides a memorable example of this conflict of interest. In March of 2007, Goldman Sachs created a CDO called Timberwolf, which was composed of $1 billion worth of mortgage-related securities. Evidence surfaced that Goldman Sachs knew the CDO was poorly constructed and within months its value declined by 80%. Significantly, one of Goldman Sachs’ clients at the time, Bear Stearns, elected to invest $300 million in the CDO. As Louise Story explains, “Around the same

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2288 Gretchen Morgenson and Louise Story, “Banks Bundled Debt, Bet Against It and Won.” Italics mine.

time that Bear was investing in Timberwolf, Goldman was placing a bet that Bear’s
shares would fall. Goldman’s short position in Bear was large enough that it would have
generated as much as $33 million in profits if Bear collapsed. It is noteworthy that
the “Volcker Rule,” which is “a yet-to-be implemented set of regulations that aim to stop
government-backstopped banks from speculative trading,” aspires to eliminate
proprietary trading altogether. Paul Volcker noted in March of 2012 that proprietary
trading often took place “at the expense of customer relationships” and that his rule
would hopefully eventuate a “rebalancing of incentives” among arrangers.

Another part of Goldman Sachs’ strategy was to act as a middleman between AIG
and other arrangers. As explained by Serena Ng and Carrick Mollenkamp, writing for
The Wall Street Journal, Goldman Sachs leveraged its reputation in order to serve as a
protection seller with other arrangers. Then, on the protection that it had just sold, it
would buy protection on the same subprime securities from AIG or other CDS protection
sellers. Since Goldman Sachs charged more to act as a protection seller than AIG and
other firms, the arranger was able to pocket the difference. In the end, Goldman Sachs
completed roughly $14 billion worth of these deals with AIG, which markedly
contributed to the downfall of the latter.

Goldman Sachs’ relentless devotion to wringing out every dollar that it could out
of the subprime mortgage market is exemplified in the arranger’s decision to purchase

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2292 Ibid.
2293 Serena Ng and Carrick Mollenkamp, “Goldman Fueled AIG Gambles --- Wall Street Firm's Role Shown in Journal Analysis; It Says Problems Hidden.”
2294 Ibid.
another subprime lender, Senderra Funding, in April of 2007. After the acquisition, Goldman Sachs converted it into a FHA lender and refinance organization. As explained by an insightful *Bloomberg Businessweek* article, Goldman Sachs’ goal was to purchase subprime loans from lenders at drastically depressed prices and then refinance them into FHA-backed loans. Once the loans were converted into FHA-backed loans, Goldman Sachs could then sell the loans to investors at a premium. For example, in September of 2008, Goldman Sachs paid Equity One, Inc. $0.63 on the dollar for $760 million worth of subprime loans. By converting those loans into FHA-backed loans, which are loans that are guaranteed by the federal government, Goldman Sachs could then sell the loans to investors for as much as $0.90 on the dollar, yielding a heady profit margin of over 40%. As the article notes, this process is entirely legal.

Renowned as “the gold standard” in investment banking, and maintaining that “integrity and honesty are at the heart” of their business, and that their “clients’ interests always come first,” one may wonder why a firm of Goldman Sachs’ stature would have ever chosen to become so heavily involved in a segment of the mortgage market that was stained with a history of questionable integrity and honesty. One compelling reason was the initial profit potential that the subprime mortgage market contained in the early part of the 2000’s. One should consider the annual profits that

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2296 Ibid.
Goldman Sachs posted once it became seriously involved in arranging deals that contained subprime mortgages. In 2002, the arranger earned $2.1 billion in profits, a number that grew to $3.01 billion at year-end 2003. The arranger then posted annual profits of $4.6 billion, $5.6 billion, $9.5 billion, and $11.6 billion in 2004, 2005, 2006, and 2007, respectively.

On March 14, 2012, an executive director of Goldman Sachs, Greg Smith, wrote a provocative op-ed piece in The New York Times, explaining why he was resigning from the arranger effective immediately. Smith cited a “decline in the firm’s moral fiber” as one of the principle reasons for his resignation, which included a profound deterioration in the quality of the firm’s leadership. In addition, Smith revealed that the most likely candidates to receive promotions at Goldman Sachs are those that successfully persuade clients to invest their funds in ways that will merely yield the biggest profits for the arranger. Smith noted that he attended meetings “where not one single minute [was] spent asking questions about how we can help clients. It [was] purely about how we can make the most possible money off of them.”

Near the end of the piece, Smith maintained that the most common question he hears junior analysts ask is: “How much money did

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2306 Ibid.
we make off the client?” Responding to this transformation of Goldman Sachs’ corporate culture, Smith concluded his piece by urging the board of directors to once again make “the client the focal point” of the arranger’s business and to eliminate the “morally bankrupt” employees, for those “who care only about making money will not sustain [Goldman Sachs] – or the trust of its clients - for very much longer.”

4.13. The Subprime-Fueled Rise and Fall of Morgan Stanley

Morgan Stanley, the youngest of the five arrangers, was founded as a spinoff from JPMorgan in 1935 after the Glass-Steagall Act forced the separation of commercial and investment banks. The firm eventually became one of the world’s leading financial institutions with a presence in 36 countries and housing over 60,000 employees. As former CEO John Mack noted, “Morgan Stanley’s business model has historically focused primarily on providing financial advisory and capital-raising services to institutional and corporate clients, with individual services principally in the wealth management sector through brokerage services.”

In 2005, as the subprime mortgage market was booming and Morgan Stanley’s earnings and stock price were lagging, then-CEO Philip Purcell came under heavy fire for being too risk-averse and failing to “deploy the firm’s capital as aggressively as his peers.” For instance, in 2004, rivals Lehman Brothers, Bear Stearns, and Goldman

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2307 Ibid.
2308 Ibid.
2309 The Financial Crisis of Our Time, 102.
2311 Ibid.
Sachs issued, respectively, $13.773 billion, $13.095 billion, and $9.506 billion worth of subprime MBSs that year, while Morgan Stanley issued $8.523 billion.\textsuperscript{2313} As one Morgan Stanley executive put it, the arranger had embraced a “culture of no.”\textsuperscript{2314} A \textit{Bloomberg Businessweek} article elaborated upon this culture, noting that while competitors “such as Goldman, Merrill Lynch, and Lehman Brothers were making acquisitions and diving into risky but profitable endeavors,” senior managers at Morgan Stanley “were sending people with bold notions back to the drawing board.”\textsuperscript{2315}

On June 13, 2005, Purcell announced his resignation\textsuperscript{2316} and a few weeks later, Morgan Stanley appointed John Mack as its new CEO.\textsuperscript{2317} Upon his arrival, Mack vowed to investors that he would double Morgan Stanley’s pretax earnings by 2010.\textsuperscript{2318} Mack also maintained that the primary problem at Morgan Stanley was that the corporate culture was too soft and timid, which was causing the arranger to miss out on lucrative opportunities.\textsuperscript{2319}

Under Mack’s leadership, Morgan Stanley elected to adopt a higher risk profile, which included an extensive move into subprime mortgages, an area that was “outside of the traditional expertise” of the arranger.\textsuperscript{2320} Part of this strategy consisted of an effort to

\begin{itemize}
  \item \textsuperscript{2313} Compass Point Research & Trading LLC, \textit{Mortgage Finance: Mortgage Repurchases Part II: Private Label RMBS Investors Take Aim – Quantifying the Risks}, 8.
  \item \textsuperscript{2315} Ibid.
  \item \textsuperscript{2318} Stanley Reed, Diane Brady, Jason Bush, and Frederik Balfour, “Morgan Stanley’s Mack Attack.”
  \item \textsuperscript{2319} Ibid.
\end{itemize}
build a global, vertically integrated residential mortgage business.\textsuperscript{2321} The arranger rapidly acquired three mortgage companies over the first eight months of 2006. One of these acquisitions came in the form of paying a $156.9 million premium for a subprime mortgage underwriter, Saxon Capital, which the arranger paid a total of $706 million.\textsuperscript{2322}

As explained by Michael Lewis in his book \textit{The Big Short}, a small group of Morgan Stanley bond traders, led by the head of the arranger’s asset-backed bond trading division, Howie Hubler, began to bet \textit{against} subprime CDOs at the end of 2004.\textsuperscript{2323} Around this time, Hubler and his group of traders purchased $2 billion worth of CDSs from protection sellers on a triple-B-rated subprime CDO that was backed by triple-B-rated MBSs. The CDS contract stipulated that Morgan Stanley would pay the protection sellers 2.5\% ($50 million) a year in exchange for the latter agreeing to assume the credit risk accompanying the CDO.\textsuperscript{2324}

Hubler’s group, however, was burdened by “a niggling problem”: by September of 2006, the CDSs had cost the arranger approximately $200 million, while failing to generate any of their anticipated returns.\textsuperscript{2325} These losses prompted Hubler’s group to sell an incredible $16 billion worth of CDSs on triple-A-rated tranches of subprime CDOs in just four months, from September of 2006 to January of 2007.\textsuperscript{2326} These triple-A-rated CDOs were also backed entirely by triple-B-rated subprime MBSs. The reason that Hubler’s team sold so much credit protection on triple-A-rated subprime CDOs was that

\textsuperscript{2322} Ibid.
\textsuperscript{2323} Michael Lewis, \textit{The Big Short: Inside the Doomsday Machine} (New York: W.W. Norton & Company, 2010), 200-201.
\textsuperscript{2324} Ibid., 203.
\textsuperscript{2325} Ibid., 205-206.
\textsuperscript{2326} Ibid., 206.
the premiums Morgan Stanley received from those CDSs were only one-tenth of the premiums that it was paying out as a CDS protection buyer. Triple-A-rated CDOs were supposedly far less risky than triple-B-rated CDOs, a view that Hubler’s team completely and uncritically accepted. From the team’s perspective, then, they were collecting virtually risk-free premiums by acting as a CDS protection seller of triple-A-rated CDOs, which would offset the running cost of paying premiums as a CDS protection buyer of triple-B-rated CDOs. According to Lewis, “Hubler felt certain [that their strategy] would one day very soon yield $2 billion in pure profits” once the triple-B-rated CDOs collapsed in value.2327

As discussed below, by the end of 2007, this strategy contributed to Morgan Stanley absorbing $9 billion worth of losses, which Michael Lewis claims is “the single largest trading loss in the history of Wall Street.”2328 While Hubler’s team correctly predicted that the triple-B-rated CDOs that were backed by triple-B-rated subprime MBSs were doomed to fail, the group and, indeed, Morgan Stanley’s upper management and risk management teams, mistakenly believed that the triple-A-rated CDOs that were also backed by triple-B-rated subprime MBSs were virtually riskless.2329 The central oversight that plagued Morgan Stanley is nicely described by Michael Lewis:

[T]hey genuinely failed to understand the nature of the subprime CDO. The correlation among triple-B-rated subprime [mortgage-backed] bonds was… 100 percent. When one collapsed, they all collapsed, because they were all driven by the same broader economic forces.2330

In other words, Morgan Stanley failed to realize that the underlying triple-B-rated subprime MBSs that were backing the CDOs that they both bought CDS protection for –

2327 Ibid., 205-206.
2328 Ibid., 215.
2329 Ibid., 207.
2330 Ibid., 214.
and sold CDS protection on – were essentially the same in the sense that they were destined to “default en masse the moment house prices stopped rising.” This oversight was made possible by the NRSROs bestowing triple-A ratings on approximately 80% of every CDO that they rated, despite having “very little history to work with in the subprime mortgage bond market, and no history at all of a collapsing national real estate market.” Quite simply, as Michael Lewis puts it, “Howie Hubler trusted the ratings.” Hubler’s team and Morgan Stanley’s management relied so heavily on the accuracy of the NRSROs ratings that they failed to question “the wisdom of owning $16 billion in complex securities whose value ultimately turned on the ability of… a Mexican strawberry picker with a single $750,000 home to make rapidly rising interest payments.”

In addition to acquiring mortgage lenders and purchasing and selling subprime-related CDSs, Morgan Stanley also became a prominent warehouse lender leading up to the subprime mortgage crisis, offering immense lines of credit to subprime lenders. For example, in 2006 alone, Morgan Stanley offered a $650 million warehouse line of credit to Accredited Home Lenders Inc., a subprime lender that eventually went under in 2007. During 2006 and into 2007, the arranger provided $3 billion worth of credit to the notorious subprime lender, New Century. According to one source, Morgan

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2331 Ibid., 208.
2332 Ibid.
2333 Ibid.
2334 Ibid., 211.
2336 Ibid.
Stanley ended up securitizing nearly $30 billion worth of residential MBSs in 2006.\footnote{Ibid., 14.} The arranger also issued $21.3 billion worth of CDOs that year.\footnote{The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States, 202.}

Viewed from the perspective of short-term profitability, these strategies paid off quickly. Morgan Stanley posted a record annual profit of $7.5 billion in 2006.\footnote{Landon Thomas, Jr., “Spinoff Set by Summer for Discover,” \textit{The New York Times} (December 20, 2006), \textit{available at} http://www.nytimes.com/2006/12/20/business/20morgan.html.} John Mack received a year-end bonus of $40 million.\footnote{Tomoeh Murakami Tse and David Cho, “First Quarterly Loss Posted in Morgan Stanley’s 72 Years,” \textit{The Washington Post} (December 20, 2007).} Galvanized by record earnings, John Mack stood in front of his board and shareholders during the arranger’s annual meeting in 2007 and declared, “Do we take a lot of risk? Yes, I think this firm has the capacity to take a lot more risk than it has in the past.”\footnote{Landon Thomas, Jr., “Morgan Stanley Chief Grappling With New Kinds of Risk,” \textit{The New York Times} (March 11, 2008), \textit{available at} http://www.nytimes.com/2008/03/11/business/11wall.html.} In March of 2007, the arranger announced its best quarter of earnings since it went public in 1986. At this point, Morgan Stanley’s profits had nearly doubled since Mack arrived in July of 2005.\footnote{Christine Harper, “Morgan Stanley Reports Record 70% Rise in Profit,” \textit{The International Herald Tribune} (March 22, 2007).} The arranger’s Chief Financial Officer, David Sidwell, conceded that month during a quarterly earnings conference call that the arranger’s subprime mortgage activities were “a significant contributor” to its financial results.\footnote{Bernstein, Litowitz, Berger, & Grossmann LLP, “Supreme Court of New York County of New York: Allstate v. Morgan Stanley,” 14.} That year, Morgan Stanley’s warehouse lines of credit to subprime lenders ballooned to $5.2 billion.\footnote{Ibid., 73.}

In the midst of these enviable March 2007 earnings, however, New Century’s struggles that same month anticipated Morgan Stanley’s own imminent decline. As the subprime mortgage market began to dry up in early 2007, New Century began to run out
of cash. While other arrangers believed that New Century was technically already in
default on its debt obligations in March of 2007, Morgan Stanley puzzlingly agreed to
lend the distressed company $265 million that was secured by New Century-originated
subprime loans.\textsuperscript{2345} A July 5, 2011 lawsuit filed on behalf Allstate Insurance Company by
the law firm Bernstein, Litowitz, Berger, & Grossmann LLP against Morgan Stanley
contains a wealth of information on the arranger’s relationship with New Century, and it
explains why the arranger would make such a questionable decision. Moreover, the
lawsuit’s description of this relationship is the most detailed presentation of an
arranger/lender relationship that I have encountered. A few words about this relationship,
therefore, are warranted.

As the lawsuit explains, a conflict of interest came to plague the arranger/lender
relationship in general, and the Morgan Stanley/New Century relationship in
particular.\textsuperscript{2346} When an arranger extends a warehouse line of credit to a lender, the idea is
that the latter will originate loans that meet certain arranger-specified standards. Once the
lender originates a certain quantity of loans that meet those standards, it is typically
authorized to draw on the arranger’s warehouse line of credit to reimburse itself. The
arranger receives the amount and type of loans that it wants, while the lender has
replenished its capital to fund and originate additional loans.

One of the reasons that an arranger would choose to outsource mortgage
origination duties to a lender was because it was more cost efficient to do so. An arranger
could also charge lenders interest for extending those lines of credit to them.\textsuperscript{2347} What

\textsuperscript{2345} Ibid., 75.
\textsuperscript{2346} Ibid., 74.
\textsuperscript{2347} Ibid., 73.
would happen, though, if an arranger noticed that a lender was funding and originating loans that were of poorer, riskier quality than it wanted?

Initially, one may be tempted to respond that the arranger should simply reject the inferior loans and force the lender to replace them with loans that meet its stated standards. Continuing with this line of thought, what the arranger should ensure is that the lender should pay for those inferior loans with its own money, rather the money the latter borrowed or intended to borrow from a warehouse line of credit. The lender may be forced to absorb substantial losses stemming from those inferior loans because they will likely be difficult to sell to other arrangers, and the mortgage borrowers may not be able to timely repay the principal that they borrowed plus interest. However, those negative consequences should, nonetheless, be borne entirely by the lender since it was the party responsible for originating the inferior loans in the first place.

As reasonable as this response might initially appear, one would be presupposing at least two things. First, one would be assuming that the lender is in a financial position that is strong enough to absorb those losses. A financially vulnerable lender, though, could be ruined if an arranger made such a decision. An arranger, in turn, would find this scenario to be problematic if it had outstanding warehouse lines of credit with that lender. This is precisely the dilemma that ensnared Morgan Stanley in the early part of 2007: if the arranger forced New Century to replace its inferior loans, the former risked losing billions of dollars in outstanding warehouse lines of credit that it had already extended to the latter.2348

Second, one would be assuming that the arranger has complete leverage over the lender. As the lawsuit cited above notes, however, Morgan Stanley held no such

2348 Ibid., 74.
advantage over New Century. As early as late-2005 and into 2006, the arranger began to realize that the quality of New Century’s loans was progressively deteriorating. Interestingly, when Morgan Stanley reacted by rejecting more and more of New Century’s loans, the lender “began to complain to Morgan Stanley about its rejection rate… [and suggested] that it would begin to shift its business to other buyers.”

In response to this threat, “Morgan Stanley relented in order to maintain its access to a steady flow of New Century mortgages available for securitization.”

From that point on, Morgan Stanley routinely purchased immense quantities of defective subprime loans from New Century for the sake of preserving their mutually profitable relationship. One former Morgan Stanley employee who had “intimate knowledge of Morgan Stanley’s loan purchasing and due diligence operations” stated that when the arranger would purchase loans that it knew violated its own stated policies, his team would refer to the decision as a “business decision” or “BD” for short. According to this employee, the team’s use of the term “BD” was a “funny way of saying, ‘Let’s do something that we shouldn’t’.”

Morgan Stanley’s interdependent relationship with New Century, then, prompted the arranger to profoundly compromise its own mortgage purchasing standards. For instance, the arranger supposedly placed a debt-to-income ratio (DTI) limit of 55% on all of its purchased subprime loans from lenders. Morgan Stanley’s stated policy of a 55% DTI limit on purchased loans meant that, if more than 55% of a given borrower’s gross monthly income went towards his or her monthly mortgage payment and mortgage-

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2349 Ibid., 69.
2350 Ibid.
2351 Ibid., 4.
2352 Ibid., 69.
2353 Ibid., 57.
related costs, then the arranger would not purchase that loan from a lender. A mortgage loan with a DTI above 55% signaled to Morgan Stanley that there was a very low probability that the borrower would be able to repay it unless he or she refinanced.\footnote{Ibid., 58.}

With this thought in mind, one should note that the Massachusetts Attorney General conducted an extensive investigation that ended in June of 2010 and concluded that Morgan Stanley knew that New Century was qualifying borrowers at low initial teaser rates instead of at the fully indexed rate. Given the prevailing interest rates at the time of the investigation, the Massachusetts Attorney General estimated that an ARM with a DTI of 41% would eventually reset at the fully indexed rate and transform into a loan with a DTI of 56%.\footnote{Ibid., 57.} Thus, Morgan Stanley should have rejected all New Century ARMs that had a DTI of 41% or higher. In the end, the investigation found that over four out of ten of the ARMs that New Century originated in Massachusetts and successfully sold to Morgan Stanley had a fully indexed DTI that exceeded 55%. Even more astounding, the investigation discovered that 29% of the ARMs that New Century originated in Massachusetts and subsequently sold to Morgan Stanley had a fully indexed DTI that exceeded 60%.\footnote{Ibid.}

Morgan Stanley’s health was further entangled in the health of New Century because the former created an early purchase, or “EP” program with the latter. Under its EP program, Morgan Stanley provided subprime lenders with what amounted to a cash advance to purchase subprime loans. According to one former Morgan Stanley employee who was involved in the arranger’s warehouse lending activities, the EP program locked

\footnote{Ibid., 58.} \footnote{Ibid., 57.} \footnote{Ibid.}
the arranger into buying New Century’s loans “no matter their quality.” As this same former employee explained, if Morgan Stanley made a cash advance to a subprime lender under the EP program and then later rejected a pool of subprime mortgages that the lender used the money to originate and initially fund, then the arranger risked losing some or all of the money that it had lent.

It was later discovered that Morgan Stanley was so desperate to keep New Century afloat in March of 2007 that the arranger even provided millions of dollars of controversial “wet funding” to New Century mortgage borrowers that month. Essentially, “wet funding” is tantamount to a cash gift that an outside party gives to a borrower at the closing table. Morgan Stanley gave those cash gifts to borrowers so that they could close on subprime mortgage loans that, in the absence of the gifts, would not have otherwise been approved. Consequently, this strategy enabled Morgan Stanley to further amplify its incoming flow of New Century subprime loans to securitize and sell to investors.

Small wonder, then, that Morgan Stanley extended a $265 million loan to New Century roughly one month before the lender filed for bankruptcy protection. If New Century failed, the arranger stood to lose far more than its $265 million loan. Morgan Stanley’s relationship with New Century was so vital to the financial health of the arranger that its traders came to refer to the lender as a “partner.”

After New Century filed for bankruptcy protection in April of 2007, Morgan Stanley initially took on greater subprime-related risks by announcing its purchase a

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2357 Ibid., 75-76.
2358 Ibid., 76.
2359 Ibid., 78.
2360 Ibid., 75.
subprime lender of its own for $6.5 billion: Crescent Real Estate Equities.\textsuperscript{2361} In June of 2007, the arranger’s fantastic earnings streak surprisingly continued, inciting a writer for *The New York Times* to affirm that the results were “a vivid demonstration of Morgan Stanley’s ability to overcome the subprime problems that have plagued its rivals.”\textsuperscript{2362} On June 14, Morgan Stanley’s stock price peaked at $70.09.\textsuperscript{2363} For the remainder of 2007, however, the downsides of Morgan Stanley’s excessive subprime-related risks came to materialize. On its books at the time, Morgan Stanley had a total CDO inventory valued at roughly $13 billion, most of which was composed of the safest, super-senior tranches, a total subprime loan inventory of $2.9 billion, and a subprime MBS inventory of $4 billion.\textsuperscript{2364}

By the time that Morgan Stanley released its earnings report for the third quarter in September of 2007, default rates on subprime mortgages sharply spiked and the arranger’s stock price had already plummeted 24% since June. Significantly, Morgan Stanley revealed that, over the previous three months, it had written down $940 million dollars due to the decreased value of risky subprime-related investments on its books. Morgan Stanley’s CFO, David Sidwell, stated, “I think given the extraordinarily difficult markets, we actually performed OK -- and we view ourselves as very well positioned to take advantage of opportunities that arise as the markets settle down.”\textsuperscript{2365} Over the course of two months, from the end of August to the end of October of 2007, Morgan Stanley

\begin{footnotesize}
\begin{enumerate}
\item Ben White, “Morgan Stanley Acquires Crescent,” *The Financial Times* (May 24, 2007). This purchase was completed on August 3, 2007.
\item The Financial Crisis of Our Time, 103.
\end{enumerate}
\end{footnotesize}
frantically attempted to reduce its subprime-related exposure, eventually reducing it to $6 billion from $10.4 billion.\textsuperscript{2366}

On December 20, 2007, Morgan Stanley announced its first quarterly loss in its 72-year history, $3.59 billion, after writing down an incredible $9.4 billion worth of subprime-related investments.\textsuperscript{2367} Then-CEO John Mack declared, “The results are embarrassing for me and the firm.”\textsuperscript{2368} Despite posting profits of $3.2 billion for the year,\textsuperscript{2369} the arranger was in such desperate straits that it accepted a $5.5 billion injection from the China Investment Corporation. In exchange for the capital injection, the investment fund received a 9.9% stake in Morgan Stanley.\textsuperscript{2370}

In 2008, when the severity of the subprime mortgage crisis began to accelerate, Morgan Stanley posted a $1.5 billion profit over the first quarter\textsuperscript{2371} and reduced its subprime exposure down to $1.8 billion.\textsuperscript{2372} Then-CEO John Mack predicted at a shareholder meeting in April of 2008 that the troubles of the subprime market were in “the eighth inning or maybe the top of the ninth,” and that the crisis was approaching its end.\textsuperscript{2373} It is interesting to note that the arranger earned $1 billion that quarter from


\textsuperscript{2368} Ibid.

\textsuperscript{2369} *The Financial Crisis of Our Time*, 102.


shorting, or betting against, subprime mortgages.\textsuperscript{2374} These developments occurred in the wake of the collapse of Bear Stearns.

The next quarter, in June of 2008, the arranger announced profits totaling $1.026 billion,\textsuperscript{2375} while Lehman Brothers and Goldman Sachs posted losses. Morgan Stanley’s Chief Financial Officer, Colm Kelleher, optimistically asserted that the arranger’s excess capital made it “well-positioned” to take on more risk once the markets improved.\textsuperscript{2376} This was a particularly startling statement when one considers the fact that the arranger had already written down over $14 billion worth of subprime-related assets at that point.\textsuperscript{2377}

On September 16, 2008, the day after the bankruptcy of Lehman Brothers, Morgan Stanley released its third quarter earnings one day early in an effort to assuage market fears over its financial standing. The arranger posted a quarterly profit of $1.4 billion. Nevertheless, the market was not impressed with the results and Morgan Stanley’s closing stock price declined 24% the next day.\textsuperscript{2378} Then-CEO John Mack later confessed that the move backfired because it came to be perceived as a sign of weakness.\textsuperscript{2379}

\textsuperscript{2376} Ben White, Francesco Guerrera, and Henny Sender, “Credit Crunch Losses ‘May Triple’,” \textit{The Financial Times} (June 19, 2008).
\textsuperscript{2378} \textit{The Financial Crisis of Our Time}, 105.
By Friday September 19, Morgan Stanley’s stock price had decreased 71% since the beginning of the year.\textsuperscript{2380} As Kate Kelly and Aaron Lucchetti noted, writing for \textit{The Wall Street Journal}, Morgan Stanley, along with Goldman Sachs, made an “ironic plea” to the SEC to temporarily ban short sales on financial stocks. The irony of their request centered on the fact that both firms serviced “scores of hedge funds,” which depended “heavily on the ability to short stocks” and they both lent “out shares used by others to short.”\textsuperscript{2381} Still, the SEC acquiesced to their demand and announced that day a temporary ban on the short selling of all 799 companies in the financial services sector.\textsuperscript{2382}

Meanwhile, in order to secure financing, Morgan Stanley considered merging with Wachovia or selling another, larger stake to the China Investment Corporation, one that would increase the firm’s holding up from 9.9% to 49%.\textsuperscript{2383} As the weekend progressed and no deal was finalized, at the behest of Morgan Stanley and Goldman Sachs, the Federal Reserve announced on Sunday night, September 21, that it had approved the two arrangers’ applications to become bank holding companies.\textsuperscript{2384} Three reporters, writing for \textit{The Wall Street Journal}, observed, “With the move, Wall Street as it has long been known -- a coterie of independent brokerage firms that buy and sell securities, advise clients and are less regulated than old-fashioned banks -- will cease to exist.”\textsuperscript{2385} Joseph Weber, writing for \textit{Bloomberg Businessweek}, claimed that the two arrangers “would never be the same,” and that the “swashbuckling, risk-taking, and

\textsuperscript{2380} Francesco Guerrera and Henny Sender, “M Stanley in Stake Sale Talks with Chinese,” \textit{The Financial Times} (September 19, 2008).
\textsuperscript{2381} Aaron Lucchetti and Kate Kelly, “Goldman, Morgan Rewrite Playbooks --- Survival Prompts Drastic Changes For Rival Titans,” \textit{The Wall Street Journal} (October 2, 2008).
\textsuperscript{2382} \textit{The Financial Crisis of Our Time}, 304.
\textsuperscript{2383} Francesco Guerrera and Henny Sender, “M Stanley in Stake Sale Talks with Chinese.”
\textsuperscript{2384} \textit{The Financial Crisis of Our Time}, 106.
financially ingenious investment banks that produced stellar returns for years - and turned Wall Street into a stunningly lucrative place for even the most junior staffers” were quickly becoming “distant memories.”

Indeed, in adopting the status of bank holding companies, the two arrangers had their corporate charters rewritten, making them commercial banks, which was “a business they had [previously] regarded as beneath their pedigrees.” Morgan Stanley, incredibly, was allegedly even discussing whether to add “automated teller machines inside its brokerage locations.”

Among the many implications of this move, Morgan Stanley and Goldman Sachs, as bank holding companies, now had short term borrowing privileges with the Fed, which ensured that their future capital needs would be met. The move also signaled to the markets that the Fed “stood firmly behind both firms.” However, their bank holding company status also subjected them to stricter capital requirements, which one economist labeled “the end of an era of extraordinary leverage.” Whereas before the move the two arrangers had leverage ratios in the twenties and even thirties, their leverage now had to be reduced to that of other commercial banks, which was around ten. Previously, as an independent investment bank, Morgan Stanley had $1.05 trillion worth of assets supported by a mere $30 billion of equity at the end of the 2007 fiscal year.

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2387 Ibid.
2388 The Financial Crisis of Our Time, 106.
2390 Jon Hilsenrath, Damian Paletta, and Aaron Lucchetti, “Goldman, Morgan Scrap Wall Street Model, Become Banks in Bid to Ride Out Crisis.”
Even after the conversion into bank holding companies, the two arrangers’ stock prices continued to plummet. Morgan Stanley announced on September 29, 2008 that Mitsubishi UFJ Financial Group, the second largest bank in the world at the time, would invest $9 billion in the company in exchange for 21% of the arranger’s stock.\textsuperscript{2393} Despite this news, Morgan Stanley’s stock plunged nearly 70% in just eleven days, down to $7.19 per share.\textsuperscript{2394} Consequently, the United States Treasury Department stepped in to reassure the Japanese bank that its investment would be protected, and Morgan Stanley was ultimately forced to sweeten the deal in order to attain the $9 billion cash injection.\textsuperscript{2395} Reportedly, Morgan Stanley underestimated the length and cost of its future ties with Mitsubishi. Over two years later, the arranger was still paying the Japanese bank $220 million each quarter in dividend payments, and that arrangement will continue “until the two parties can come to an agreement to end them or until the stock trades above $37.875 for 20 days out of 30 consecutive trading days.”\textsuperscript{2396} As of July of 2012, the arranger’s stock price is below $15.

One should note that Mitsubishi’s backing of Morgan Stanley also proved to be insufficient for rescuing the arranger. On October 28, 2008, Morgan Stanley received a fresh $10 billion in Troubled Assets Relief Program funds\textsuperscript{2397} and had already borrowed

\textsuperscript{2393} Greg Farrell and Henny Sender, “Japan’s Stake in Morgan Stanley ‘An Alliance’,” \textit{The Financial Times} (September 30, 2008).
over $100 billion, undisclosed, from the Fed. 2398 On a single day, September 26, 2008, Morgan Stanley borrowed $47.6 billion. All told, the arranger borrowed money from the Fed through its “Primary Dealer Credit Facility” program an astonishing 212 times. 2399 Over the course of the final quarter of 2008, the arranger posted a $2 billion loss, which is a testament to how vulnerable the arranger was during this time. 2400

In 2009, Morgan Stanley earned approximately $857 million before taxes. 2401 That same year the arranger “closed the book” on its disastrous 2007 acquisition of Crescent Real Estate Equities, one that ultimately led to over $900 million in losses. 2402 The next year, in 2010, the arranger earned $4.5 billion. 2403 Reacting to these earnings, one writer for The Wall Street Journal maintained that they “showed how much the 75-year-old New York company” was trying “to forge a new identity in the wake of the financial crisis that nearly destroyed it.” 2404 Part of this identity included the departure of “high-rolling traders,” a lower overall risk profile, and an increased focus on “lower-octane businesses.” 2405 The arranger earned $4.2 billion in 2011, 2406 but was “still seen as

2398 On September 21, 2008, John Mack publicly stated that Morgan Stanley was “in the strongest possible position,” when, just eight days later, the arranger was $107 billion in debt with the Fed. Please see: Bob Ivry, Bradley Keoun, and Phil Kuntz, “Big Banks Got $13 Billion in Undisclosed Fed Loans,” The Washington Post (November 29, 2011).
2400 The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps, 137.
2404 Ibid.
2405 Ibid.
the potential weak link on Wall Street,” given the disproportionately high cost to insure its debt.2407

4.14. Conclusion

In the preceding sections, I have attempted to provide a sketch of how the five largest arrangers contributed to the subprime mortgage crisis. By acquiring or closely working with subprime lenders, purchasing subprime loans with short-term funds, pushing for the abolition of capital reserve requirements, and relentlessly packaging subprime loans into MBSs and CDOs, those five arrangers were a key catalyst for spreading the subprime contagion worldwide. By the third week of September in 2008, “Wall Street as it was known - loosely regulated, daringly risky, and lavishly rewarded - was dead.”2408 The two remaining stand-alone investment banks, Goldman Sachs and Morgan Stanley, continue to struggle in 2012. Goldman Sachs’ stock price, as of February 2012, is 52% lower than its high in October of 2007, while Morgan Stanley’s stock price is down over 78% from its high in June of 2007. In a true sign of the times, Goldman Sachs announced in July of 2012 that it is building “an in-house bank to lend money to wealthy people and companies.”2409 Liz Rappaport describes this strategy as a cautious attempt to reshape its business as “new regulations, market turmoil and a sluggish economy” have dried up previously profitable revenue streams stemming from sources like trading and investment banking.2410

2408 Susanne Craig, Jeffrey McCracken, Aaron Lucchetti, and Kate Kelly, “The Weekend That Wall Street Died – Ties That Long United Strongest Firms Unraveled as Lehman Sank Toward Failure.”
2410 Ibid.
AIGFP, for its part, sold more credit protection on subprime MBSs and CDOs than it could ever hope to provide. By excessively absorbing the credit risk of so many of the arrangers’ subprime securitizations, AIGFP not only directly contributed to the collapse of its parent company, but it also enabled arrangers to securitize ever more subprime mortgage products, since they seemingly did not have to bear as much of the credit risk that those products carried with them. As of February 2012, AIG’s stock price is approximately 98% lower than its high in May of 2007.
Chapter Five

5.0. The Credit Rating Agencies

5.1. Introduction

On March 16, 2009, a scathing op-ed piece that was co-written by Jerome Fons and Frank Partnoy appeared in The New York Times.2411 In this piece, the two authors inveigh against the credit rating industry in general and the two largest credit rating agencies, Moody’s and Standard and Poor’s, in particular. At one point, they declare:

No one has been more wrong than Moody’s and S&P. Less than a year ago both gave high ratings to 11 of the largest distressed financial institutions. They put the insurance giant A.I.G. in the AA category. They rated Lehman Brothers an A just a month before it collapsed. Until recently, the agencies maintained AAA ratings on thousands of nearly worthless subprime-related securities.2412

In this section, I will attempt to discern precisely how the three largest credit rating agencies contributed to the subprime mortgage crisis. Pursuant to this goal, I will begin by sketching out a brief history of the credit rating industry, focusing especially on why credit ratings were needed in the first place and the particular goods that the credit rating agencies were initially providing to the investing community. After examining the function of credit ratings, I will then argue that, in the early-to-mid 1970’s, there were two key developments in the credit rating industry that helped give rise to incentives for the three largest credit rating agencies to act in unreasonable and irresponsible ways. The first development was the change in the way in which the credit rating agencies were compensated, while the second development was the creation of the NRSRO status,

2412 Ibid.
which largely insulated them from competition. I will contend that the confluence of these two developments enabled Moody’s, Standard and Poor’s, and Fitch to devalue the importance of their respective reputations for providing accurate credit ratings. Ultimately, I will demonstrate that the three largest credit rating agencies were part of an incentive structure that abetted them to function in profitable, though short-sighted, ways.

5.2. A Short History of the Credit Rating Industry

The history of credit ratings in the United States can be traced back to the seventeenth and eighteenth centuries as “colonial importers customarily extended up to a year of credit to their retail customers, shopkeepers, and general stores.” This nascent stage of credit ratings in America was both crude and inefficient. As Frank Partnoy observes, “Payments were often late… [borrowers’] letters of reference were faked or forged, detailed financial data were not available, and the process was tediously slow.” Those willing to extend credit were largely unable to accurately judge the extent to which a given borrower was a good or poor credit risk.

It became apparent after the major financial crisis of 1837 that “the conditions which governed credit granting” were one of “the chief contributory causes of the crash and depression which followed.” Merchants began to grasp “the necessity of clearer and more thorough scrutiny of credit risks.” The heightened importance of credit ratings during a financial crisis is understandable, for “as the probability increases that any individual creditor will not be able or willing to pay its debts,” so too is there an

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2414 Ibid.
2415 Ibid.
2416 Ibid.
increase in “the value of information about [the] ability or willingness to pay debts.”

One should also note that “[t]elegraphy, [an] improved postal service, and fast freight by rail and steamboat encouraged [American] citizens to strike bargains over vast distances” during this period. As developments in technology, transportation, and communication began to outpace “economic, legal, and social infrastructures” in America during the late 1830’s and early 1940’s, a premium began to be placed on timely and accurate credit ratings. Trading at vast distances prevented one from “looking [at] another man in the eye,” creating a need for an independent third-party to do the “looking” for entrepreneurs and businessmen across the country.

Rather fortuitously, the failed silk businessman, Lewis Tappan, had kept “detailed credit information about current and prospective customers, which included many commercial enterprises” over roughly the previous decade. The high demand for this information after the crisis of 1837 enabled Tappan to form The Mercantile Agency in 1841, “the first mercantile credit industry” in America. Tappan’s motto was “Man’s confidence in Man” and his business became wildly successful. By 1846, Tappan had hired 679 local informants to gather information on the credit-worthiness of men, and by 1851 this figure expanded to over 2,000 informants. Perhaps most impressive of all, The Mercantile Agency eventually claimed that it “could find and appraise nearly anyone in a crowd of 29 million (the U.S. population in 1857)… in 7 days.”

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2417 Ibid.
2419 Ibid., 101.
2420 Ibid.
2422 Ibid., 637.
2423 *Born Losers*, 163.
2424 Ibid., 101.
2425 Ibid., 103.
After ten years in business, Tappan had credit information on men filling “more than 100 books… extending to 600 and 700 pages each” with each page holding up to “1,500 words of tiny calligraphy.”\(^\text{2426}\) The entries in these books were terse, but descriptive. A memorable example can be found in an 1848 entry for J.B.N. Gould, “a tailor who absconded from Worcester,” which reads: “Failed & now in Boston, be sure & never trust him, will always be worthless.”\(^\text{2427}\) By 1859, Robert Graham Dun, who became the sole proprietor of The Mercantile Agency, “issued the Dun rating book,” which contained credit information on over 20,000 names.\(^\text{2428}\) John M. Bradstreet, who founded a credit rating firm in 1849, published the world’s first commercial ratings book in 1857.\(^\text{2429}\)

The late 1800’s in America was a particularly prosperous period for reputable credit raters, creating conditions for the credit rating market to grow and providing incentives to evaluate credit risk in other areas like stocks and bonds.\(^\text{2430}\) Standard and Poor’s predecessor, Poor’s Publishing Company, began publishing *Poor’s Manual*, which analyzed “various types of investments, including bonds.”\(^\text{2431}\) Wall Street analyst, John Moody, noticed in the early 1900’s the enormous potential of rating bonds in terms of their credit risk and declared, “Somebody, sooner or later, will bring out an industrial statistical manual, and when it comes, it will be a gold mine.”\(^\text{2432}\) Moody initially attempted to analyze “elaborate statistics and detailed operating and financial data” that was being issued in the form of reports on the railroad industry, with the aim of

\(^{2426}\) Ibid.  
\(^{2427}\) Ibid., 111.  
\(^{2429}\) Ibid.  
\(^{2430}\) Ibid.  
\(^{2431}\) Ibid.  
\(^{2432}\) Ibid.
synthesizing that data into “a single rating symbol for each bond” issued by a given railroad company.\textsuperscript{2433} If able to successfully determine the relative credit risk accompanying bonds issued by railroad companies, Moody believed that he could profitably sell his ratings to interested investors.

Prior to and even after the publication of his book entitled \textit{Analysis of Railroad Investments} in 1909, Moody was confronted by opposition from both bankers and Wall Street analysts.\textsuperscript{2434} One “old Wall Street buccaneer” called Moody a “young pipe dreamer” who was potentially throwing away “ten years’ experience of learning the rules of the game,” by choosing to “give the public all of the facts regarding the [railroad] corporations for the price of a book.”\textsuperscript{2435} This same man added, “Use your information yourself; don’t be a philanthropist. There’s no money in it!”\textsuperscript{2436} Moody himself stated that the publication of the book “raised a storm of opposition, not to mention ridicule from some quarters.”\textsuperscript{2437}

Five years after the publication of \textit{Analysis of Railroad Investments}, Moody’s Investors Service was incorporated and, by 1922, a formal rating department was established.\textsuperscript{2438} Moody’s Investors Service was covering nearly 100 percent of the U.S. bond market by 1924.\textsuperscript{2439} Three other rating agencies also emerged shortly after Moody’s published its first ratings in 1909: Poor’s Publishing Company (1916), Standard Statistics

\begin{footnotesize}
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\item \textsuperscript{2433} Ibid., 637-638.
\item \textsuperscript{2434} Ibid., 638.
\item \textsuperscript{2435} Ibid.
\item \textsuperscript{2436} Ibid.
\item \textsuperscript{2437} Ibid.
\item \textsuperscript{2438} Ibid.
\item \textsuperscript{2439} Ibid. 638-639.
\end{itemize}
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Company (1922), and Fitch Publishing Company (1924). Poor’s merged with Standard Statistics in 1941 to form Standard and Poor’s.

When one examines the American credit rating market in the 1920’s, at least three points are worth considering. First, the credit rating business model was one in which investors paid for the published ratings. Only those investors who paid the credit rating agencies’ subscription fees would have access to the ratings. This investor-pays model lasted until the early 1970’s.

Second, arrangers of bonds frequently “opposed the ratings,” viewing them as unwelcome intrusions “into the corporation’s business.” At least initially, even the very act of an arranger challenging its rated bonds could, from the investor’s perspective, provide insight into whether a given arranger’s bonds were desirable investments. Partnoy provides a memorable example of an arranger receiving a low rating and then threatening an unnamed credit rating agency by declaring: “Send your man around, and we’ll show him a few things that will cause him to raise your rating.” Soon enough, however, arrangers came to terms with the presence of credit rating agencies and realized that they “had no choice but to provide the agencies with valuable information, including non-public information.” One should note that, despite the fact that such non-public information could have been and perhaps was valuable to the credit rating agencies, as it could help them generate more accurate ratings, this exchange of information and

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2440 Ibid., 639.
2441 Ibid.
2442 Ibid., 640.
2443 Ibid.
2444 Ibid., 640.
2445 Ibid.
arranger/rating agency employee interaction invited bribery. In return for higher ratings, arrangers could confer some sort of benefit to the rating agencies.2446

Finally, the competition to enter into the credit rating market during this period was quite low, as evinced by the flurry of entrants2447 who seemingly had no trouble initially taking up the profession, while the competition within the credit rating market was fierce.2448 To illustrate this latter point, Partnoy states, “Every time an agency assigned a rating, that agency’s name, integrity, and credibility were subject to inspection and critique by the entire investment community.”2449 One of a credit rating agency’s greatest assets would have been its reputation. Earning a reputation for inaccurate ratings would have been fatal to a credit rating agency during this period.

When the stock market crashed in 1929, the rating agencies were forced to lower their ratings on a substantial number of bonds.2450 Yet, it is surprising that the demand for credit ratings in the early 1930’s actually increased. One would perhaps expect the credit ratings market to contract during this period, since the reputations of the rating agencies had to have been tarnished for failing to anticipate the sharp drop in the value of many bonds. What could possibly explain investors’ increased reliance on credit ratings during this period, one in which it became reasonable to question the rating agencies’ ability to accurately rate bonds?

Partnoy provides a compelling explanation. In order to quell the fear, uncertainty, and distrust that was permeating the American market at the time, the first formal rule

2446 Ibid.
2447 Ibid., 639.
2448 Ibid., 640.
2449 Ibid.
2450 Ibid.
incorporating credit ratings was implemented in 1931.2451 According to Partnoy, “[t]he United States Treasury Department, through the Comptroller of the Currency, adopted credit ratings as the proper measures of the quality of the national banks’ bond accounts.”2452 The regulation stipulated that a national bank could hold, at cost, bonds rated BBB or higher by a credit rating agency. Any bonds that were rated lower than BBB by a credit rating agency required banks to perform fractional write-offs to help offset the additional risk of those bonds.2453 This decision by the United States Treasury Department received “wide attention at the time, including a front-page article in The Wall Street Journal.”2454 Over the next few years, several state banks adopted this ruling as well, including New York, Ohio, and Alabama.2455

On February 15, 1936, the Comptroller of the Currency issued a pivotal and landmark ruling, one that was “promulgated as to further limitations and restrictions on the purchase and sale of investment securities for the bank’s own account.”2456 As stated by the comptroller in the ruling: “The purchase of ‘investment securities’ in which the investment characteristics are distinctly and predominately speculative, or ‘investment securities’ of a lower designated standard than those which are distinctly and predominately speculative is prohibited.”2457 In a footnote to this sentence, the comptroller additionally noted that “[T]he terms employed herein may be found in

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2451 Ibid., 687.
2452 Ibid.
2453 Ibid.
2454 Ibid., 687-688.
2455 Ibid., 688.
2456 Ibid.
2457 Ibid.
recognized rating manuals, and where there is doubt as to the eligibility of a security for purchase, such eligibility must be supported by not less than two rating manuals.2458

This ruling carried with it several important implications. Prior to the ruling, many banks “invested in bonds lower than BBB,” despite the required fractional write-offs.2459 After the ruling, however, banks were only permitted to invest in bonds rated BBB or higher, which effectively reduced the number of “publicly-traded bonds that banks could purchase” by over 50%.2460 The demand for bonds rated BBB or higher dramatically rose.

Concomitant with this increased demand for BBB rated or higher bonds was the perhaps unavoidable shift in the way that credit rating agencies were perceived. No longer mere publishers of credit ratings, the credit rating agencies came to be viewed as “sources of authority… regardless of what information the rating agencies actually generated.”2461 In other words, the value of credit ratings, following the ruling, stemmed mainly from the fact that they determined which bonds could be purchased by banks and which could not. The value of credit ratings turned away from whether these ratings were accurate or not. The authority of determining which bonds were eligible for investment now had its source in the credit rating agencies. This shift in credit ratings’ value was fortunate for the credit rating agencies, for the accuracy of their ratings began to be questioned after the Great Depression.

2458 Ibid.
2459 Ibid., 689.
2460 Ibid., 688-689
2461 Ibid., 689. Italics mine.
Partnoy incisively notes that even the Comptroller who issued the ruling, J.F.T. O’Connor, seemed uneasy over “the potentially perverse effects of the ruling.”\textsuperscript{2462} O’Connor declared in front of the California Banker’s Association just three months after the ruling that “[t]he responsibility for proper investment of bank funds, now, as in the past, rests with the Directors of the institution, and there has been and is no intention on the part of this office to delegate this responsibility to the rating services, or in any way to intimate that this responsibility may be considered as having been fully performed by the mere ascertaining that a particular security falls within a particular rating classification.”\textsuperscript{2463} The comptroller was suggesting that “the proper investment of bank funds” was not tantamount to simply putting money into a bond that was rated BBB or higher by two more rating agencies. Yet the ruling itself seemed to imply that the credit rating agencies have a special authority, one fit for discerning which bonds have low credit risks and which do not. The message that the comptroller was apparently trying to convey was that a bond rated BBB or higher by two or more credit rating agencies was a necessary, but not sufficient condition for making that bond worthy of investment for banks.

From 1940 through the early 1970’s, credit ratings “did not become significantly more important” as “no major new credit rating dependent regulation[s]”\textsuperscript{2464} came into being and there was “a lack of volatility in bond prices.”\textsuperscript{2465} The default of Penn Central Railroad in 1970 on $82 million of commercial paper, and the ensuing liquidity crisis that followed, contributed to a situation in which arrangers of bonds sought out ways to

\textsuperscript{2462} Ibid.
\textsuperscript{2463} Ibid.
\textsuperscript{2464} Ibid., 690.
\textsuperscript{2465} Ibid., 646.

The idea behind the concept was to “designate agencies whose credit ratings could be used by broker-dealers for purposes of complying with the SEC’s Net Capital Rule.” The SEC adopted the Net Capital Rule (Rule 15c3-1) in 1975 and the rule required “broker-dealers, when computing net capital, to deduct from their net worth certain percentages of the market value of their proprietary security positions.” Designed to help protect customers of broker-dealer firms in the event that the firm fails, the rule also required those firms to set aside a specified percentage of liquid assets for the sake of immediate liquidation should they fall beneath minimum capital requirements. The credit ratings assigned by NRSRO’s would indicate the percentage that the firm would have to deduct. A firm holding assets that were highly rated by the NRSRO’s would be able to set aside less capital, enabling it to lend and, hopefully, make more money.

It is truly remarkable that the SEC did not define the term “NRSRO” in the Net Capital Rule (Rule 15c3-1) and as future regulations began utilizing the term as well, they simply referred back to the Net Capital Rule. The SEC did not announce the need

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2469 Ibid.
2470 Ibid.
2472 Ibid.
for a definition of an NRSRO until December of 1997 and did not offer a formal
definition of it until April of 2005. Although the SEC offered no guidelines as to what
constitutes an NRSRO, they nevertheless “grandfathered” Moody’s, Standard and Poor’s,
and Fitch as the original NRSRO’s. From 1975 to 2000, only four additional firms
were recognized as NRSRO’s, but by the turn of the century mergers reduced the number
of NRSRO’s to the original three.

Since 1975, NRSRO’s have been “incorporated into hundreds of rules, releases,
and regulatory decisions” including areas like securities, pensions, banking, insurance
regulation, and real estate. As of November of 2012, there are nine NRSRO’s:
Moody’s, Standard and Poor’s, Fitch, DBRS Ltd., A.M. Best, Japan Credit Rating
Credit Ratings.

5.3. What is the Function of the Credit Rating Agencies?

According to Moody’s Investors Service’s “Code of Professional Conduct,”
published in November of 2008, the main roles that Moody’s carries out are issuing
credit ratings and monitoring those issued ratings. Fitch and Standard and

2473 The Securities and Exchange Commission, “Definition of Nationally Recognized Statistical
2475 Frank Partnoy, “How and Why Credit Rating Agencies are Not Like Other Gatekeepers” (May 2006),
at http://www.sec.gov/about/offices/ocr.shtml.
2477 Moody’s Investors Service, Code of Professional Conduct (June 2011), available at
Poor’s2479 make identical claims in their respective codes of conduct. Moody’s defines a credit rating as “an opinion regarding the creditworthiness of an entity, a debt or financial obligation, debt security, preferred share or other financial instrument, or of an issuer of such a debt or financial obligation, debt security, preferred share or other financial instrument, issued using an established and defined ranking system of rating categories.”2480 Credit risk is defined as “risk that an entity may not meet its contractual, financial obligations as they come due and any estimated financial loss in the event of default.”2481 Credit ratings, then, are opinions of the probability that a debt instrument will default, as well as opinions of the severity of loss should that debt instrument, in fact, happen to default. In short, the credit rating agencies are in the business of credit risk differentiation, a fundamental requirement for global capital market order. They assign ratings to corporate bonds, preferred stock, commercial paper, mutual funds, municipal obligations, infrastructure projects, and even sovereign nations.2482

The three largest credit rating agencies are also abundantly clear about what their ratings are not. Borrowing again from Moody’s “Code of Professional Conduct,” one discovers that credit ratings are not “statements of current or historical fact,” nor are they to serve as “investment or financial advice,” recommending that an investor should “purchase, sell, or hold particular securities.”2483 Both Fitch’s and Standard and Poor’s

2483 Code of Professional Conduct, 6.
codes of conduct contain similar disclaimers. The apparent reason for these disclaimers is that the risk that credit ratings assess is only one factor in an investor’s decision-making process. Credit ratings do not account for factors like the price of the debt instrument, its term, the likelihood of prepayment, or other relevant characteristics that should play a part in an investment decision.

One of the primary functions of the credit rating agencies is to help overcome the difficulties associated with asymmetric information. When information asymmetry exists in the market, sellers have superior information about the quality of their product when compared to buyers, but they cannot “costlessly convey this information” to them. Credit rating agencies can help buyers (investors) “pierce the fog” of asymmetric information by providing information about “the amount of credit that can be extended” to arrangers of securities “without undue risk.”

As opposed to having investors perform time-consuming, costly, and duplicative research on the credit risk of issued securities, credit rating agencies can improve the efficiency of the securities market by equipping investors with pertinent information that may factor into the decision of how to allocate their capital. Similarly, arrangers of securities can, by way of credit ratings, make investors more confident in the quality of their products as well as pay a lower interest rate on higher rated securities, thus making them more profitable.

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2484 Fitch Ratings Code of Conduct, 16; Rating Services Code of Conduct, 4.
2488 Frank Partnoy, “The Siskel and Ebert of Financial Markets?,” 635.
2490 Ibid.
The question remains, however, as to how credit rating agencies generate their credit ratings. The credit rating process usually begins with the arranger approaching a credit rating agency to have either its firm or one or more of its securities rated. In response to this request, the credit rating agency “assigns a lead analyst” to that arranger who then “conducts a preliminary analysis to prepare the rating.” This analysis is based upon information attained from both the arranger and non-arranger sources “in order to gain a better understanding of the firm and its environment.” The analyst also conducts meetings with a portion of the senior management staff. Once the relevant information has been gathered and examined, the analyst submits a report to an ad hoc rating committee, who then “proposes a recommendation in the creditworthiness” of the arranger or its securities. Should the lead analyst disagree with the proposed rating, he or she can protest and “the matter can be referred to an internal appeals court.”

One professor of business administration at the University of Pittsburgh has concluded that “only seventy-five percent of the rating process is based on statistical information and equations, and that twenty-five percent is subjective.” Warren Kornfield, Managing Director at Moody’s, stated that Moody’s analyzes over fifty specific factors about the loans in a pool that comprises a mortgage-backed security, including the borrowers’ FICO scores, the amount of equity they have in their homes, how fully they documented

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2492 Ibid.
2493 Ibid.
2494 Ibid.
2495 Ibid.
2496 Ibid.
2497 Frank Partnoy, “The Siskel and Ebert of Financial Markets?,” 652
2498 Ibid., 658.
their assets on the loan applications, and whether the loans are for the sake of refinancing or purchase.2498

Before the credit rating agency releases the rating, the arranger is allowed to “review the press release for factual verification and to ensure that no confidential information is disclosed.”2499 If an arranger disagrees with the rating, the rating may be appealed by way of “providing new and important information or by pointing out the rating’s reliance on incorrect information or dubious sources.”2500 The credit rating process concludes by the credit rating agency issuing “a press release that contains the rating as well as the rationale justifying it.”2501

5.4. A Brief Analysis of the Credit Rating Industry Leading Up to the Subprime Mortgage Crisis

One of the key developments in the credit rating industry has been the adoption of the arranger-pays model in the early 1970’s. As mentioned before, the primary source of revenue for the credit rating agencies prior to this period was from subscriptions purchased by investors.2502 The advent of low-cost photocopying technology in the early 1970’s, however, gave rise to a free-rider problem: the payments by the users of the ratings, the investors, were either suboptimal or unenforceable.2503 For example, one

2499 Stéphane Rousseau, “Enhancing the Accountability of Credit Rating Agencies: The Case for a Disclosure-Based Approach”, 12.
2500 Ibid.
2501 Ibid.
investor could pay the asking price for the published ratings, make several photocopies of the ratings, and sell them to other interested investors for a price well below that of the asking price. From the credit rating agencies’ perspective, what was of concern was the reduction in revenue due to the decrease in investors paying the asking price. In short, inexpensive photocopying technology enabled parties to benefit from the ratings, while precluding the credit rating agencies from being completely compensated for those conferred benefits.

This free-rider problem posed an interesting dilemma for the credit rating agencies. The party that was supposed to be benefiting from the ratings, the investors, could no longer be relied upon to fully compensate the credit rating agencies for their services. At the same time, there was nevertheless a demand for those services, since it would be economically inefficient for investors to perform their own research on credit risk. The solution was found by turning to the arranger-pays model. Instead of having investors pay for access to credit ratings, arrangers and issuers of bonds and securities could pay the credit agencies to have their financial instruments rated. The turbulence that was present in the United States’ economy during this time period gave arrangers the incentive to have their products rated, as they wanted to reassure nervous and fearful investors.2504 Still, this development severed the economic linkage between those who rely on credit ratings and those who provide them. The credit rating agencies were now being chosen and compensated by a party whose interests were not necessarily aligned with those who were primarily using the ratings.

Steven Schwarcz cites a memorandum from Kenneth C. Kettering in which he speculates that the shift to the arranger-pays model is the result of the credit rating

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agencies’ agendas. Generally speaking, arrangers can be considered to be a more reliable source of revenue when compared to investors. The demand of investors is harder to predict and their payments are more difficult to acquire. This change in business model would have likely been desired by the credit rating agencies. More importantly, the investor-pays model burdened the credit rating agencies with a degree of responsibility that is not present in the arranger-pays model: namely, directly selling ratings to investors could appear to make the credit rating agencies more culpable for inaccurate or misleading ratings. The three major credit rating agencies stress how their ratings are available to the public free of charge, a fact that perhaps underscores, at least from their perspective, a lack of responsibility to those choosing to use the ratings. One who pays for a given good or service may be in a better position to legitimately express one’s dissatisfaction with the provider of that good or service when compared to one who is receiving the same good or service for free.

Up until the turn of the century, credit rating agencies had a “remarkable track record of success in their ratings.” A March 30, 1991 *Economist* article mentioned how “only one company with an investment-grade rating from Moody’s has defaulted on long-term debt” in twenty years. An “internal analysis” performed by Standard and Poor’s in January 2001 found that “all ‘A’ rated companies at the beginning of a given year would have an 87.94% chance of maintaining that same rating by year end.” The stability of credit ratings during this period seems to suggest that the transition into the arranger-pays model did not threaten the credibility of the ratings.

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2506 Ibid.
2507 Ibid., 13.
2508 Ibid.
2509 Ibid., 13-14.
Over the last decade, however, the three major credit rating agencies have had to downgrade an incredible number of their ratings. For instance, all three credit rating agencies rated Enron at investment grade just four days before their bankruptcy filing in 2001, while all three rated WorldCom at investment grade a scant 42 days before it filed for bankruptcy in 2002.\textsuperscript{2510} Fitch downgraded $18.4 billion in subprime residential mortgage-backed securities that it rated in 2006\textsuperscript{2511} and, as of October 2008, Standard and Poor’s had “downgraded more than two-thirds of its investment-grade ratings,” while Moody’s downgraded over “5,000 mortgage-backed securities.”\textsuperscript{2512} After recounting the recent struggles of the three largest credit ratings to the House Oversight and Government Reform Committee, the chairman of the Committee, Representative Henry Waxman, stated, “The story of the credit rating agencies is a story of colossal failure.”\textsuperscript{2513} I will now examine some of the criticisms directed at the three largest credit rating agencies and seek to explain how and why they contributed to the subprime mortgage crisis.

5.5. Criticisms of the Three Largest NRSRO’s

One of the more forceful criticisms leveled against the three largest credit rating agencies is that they have been insulated from lawsuits throughout their tenure as NRSRO’s, which has, in turn, created conditions that were fertile for moral hazard. Partnoy argues that the legal protection that Moody’s, Standard and Poor’s, and Fitch have enjoyed as NRSRO’s has its basis in two main claims. The first claim is that they

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  \item\textsuperscript{2510} Richard Johnson, “An Examination of Rating Agencies’ Actions Around the Investment-Grade Boundary,” \textit{Federal Reserve Bank of Kansas City}, (February 2003), 1.
  \item\textsuperscript{2513} Ibid., 4.
\end{itemize}
are members of the press and that their issued credit ratings are speech, which is “privileged” in the United States.\textsuperscript{2514} If they are, in fact, members of the press, then they are “protected from liability by the mandate of the First Amendment that there shall be ‘no law… abridging the freedom… of the press.’”\textsuperscript{2515}

The “speech” or ratings are also, by this argument, protected by the “actual malice standard” that was established in the landmark and unanimous Supreme Court decision \textit{New York Times Co. v Sullivan} in 1964. \textit{The New York Times} published a full-page advertisement on March 29, 1960 that was paid for by civil rights activists. The advertisement contained criticisms of “the police of Montgomery, Alabama, for its conduct in demonstrations there.”\textsuperscript{2516} After the publication of the advertisement, L.B. Sullivan, the elected city commissioner whose duties included supervising the Montgomery police, sued both the activists and \textit{The New York Times} for libel and was initially awarded $500,000. The Supreme Court, interestingly enough, reversed the decision in support of the United States’ “profound national commitment to the principle that debate on public issues should be uninhibited, robust, and wide-open.”\textsuperscript{2517} The Supreme Court held:

\begin{quote}
The constitutional guarantees [of the First Amendment] require, we think, a federal rule that prohibits a public official from recovering damages for a defamatory falsehood relating to his official conduct unless he proves that the statement was made with ‘actual malice’ – that is, with knowledge that it was false or with reckless disregard of whether it was false or not.\textsuperscript{2518}
\end{quote}


\textsuperscript{2516} Ibid., 5.

\textsuperscript{2517} Ibid.

\textsuperscript{2518} Ibid.
Thus, as members of the press, in certain circumstances, the credit rating agencies cannot be held liable unless they acted with “actual malice,” knowingly publishing false information or recklessly publishing information whether it is false or not.  

For instance, in June of 1996, Orange County, California sued Standard and Poor’s for professional negligence and breach of contract, claiming that eleven of the county’s bonds were rated too high. These excessively high ratings enabled County Treasurer Robert Citron to use the proceeds of those debt issues to move forward with a risky investment strategy, one that eventually contributed to the county’s declaration of bankruptcy in December of 1994. Orange County sought $2 billion in damages, but “the court ruled that the First Amendment barred claims for negligence and breach of contract.” The suit resulted in “a paltry settlement of $140,000, roughly 0.007% of the claimed damages.”

The second claim, found in slightly different forms in Moody’s, Standard and Poor’s, and Fitch’s respective codes of conduct and elsewhere, is that issued credit ratings are mere “opinions” and “not recommendations to buy, sell, or hold securities.” For instance, in Standard and Poor’s “Rating Services Code of Conduct,” published in December of 2008, there is the following disclaimer:

Ratings do not constitute investment, financial or other advice. Ratings are not recommendations to purchase, hold, or sell a particular security or to make any other investment decision. Ratings and other opinions do not comment on the suitability of an investment for a particular investor and should not be relied on when making any investment decisions.

2519 Ibid., 1.
2521 Frank Partnoy, “The Paradox of Credit Ratings,” 20
2522 Ibid.
2523 Rating Services Code of Conduct, 4.
Due to the fact that future cannot be known, the argument maintains, credit analysis must necessarily belong in the sphere of opinion. As certain sorts of opinions receive constitutional protections, a pertinent question is whether the NRSRO’s published “opinions” (their issued credit ratings) are the kind that is fit for receiving those protections.

In a seminal Supreme Court case involving the protection of opinions, *Milkovich v. Lorain Journal* in 1990, the Court ended up making a crucial distinction between opinions that do not “contain a provably false factual connotation” from those that do.2524 Opinions that do not “contain a provably false factual connotation” receive “full constitutional protection,” but those opinions that do contain such a connotation “are subject to suits under the common law of defamation.”2525

A superb example of an NRSRO defending itself against a defamation charge is the *Jefferson County School District v. Moody’s Investors Services, Inc.* case, which took place in the Court of Appeals for the Tenth Circuit. The Jefferson County School District in Colorado decided to issue new bonds at lower interest rates that were available at the time in an effort to raise money. Previously, they hired Moody’s to rate their bonds, but on this occasion they chose to hire Standard and Poor’s and Fitch instead. On October 20, 1993, the school district priced the bonds. Controversy arose when Moody’s, just two hours after the pricing of the bonds, “wrote in its electronic publication Rating News that ‘[t]he outlook on the district’s general obligation debt is negative, reflecting the district’s ongoing financial pressures.’” 2526 This unsolicited opinion provoked many buyers of the

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2525 Ibid.
2526 Ibid.
bonds to cancel their orders, which, in turn, forced the school district to reprice the bonds, offering them at a higher rate.

The ability to use unsolicited opinions as a “weapon” that potentially harms arrangers that choose to take their business to other credit rating agencies is alarming. For present purposes, however, the relevant point is that after the school district sued Moody’s for $769,000 to recover its increased interest expense, the court dismissed the case because “the phrases ‘negative outlook’ and ‘ongoing financial pressures’ are themselves too vague to be ‘provably false.’”\(^{2527}\) Moreover, the school district could not “identify a specific false statement reasonably implied from Moody’s article.”\(^{2528}\)

While it is true that lawsuits brought against the three largest NRSRO’s in the past have typically been “dismissed or settled on favorable terms to the rating agencies,”\(^{2529}\) it is questionable whether this trend will continue in the wake of the current economic crisis. The “credit ratings are opinions, which are protected by the First Amendment” defense may be able to shield those NRSRO’s from accusations of defamation, but as Grais and Katsiris note, investors that choose to sue Moody’s, Standard and Poor’s, and Fitch, will likely not be filing defamation suits.\(^{2530}\) As for the “credit rating agencies are members of the press” defense, the decision reached in the case of In re Fitch, Inc. makes one wonder whether this defense, too, will be able to withstand future scrutiny. In 2003, the United States Court of Appeals for the Second Circuit in New York concluded that Fitch was not a member of the press for two primary reasons. First, unlike “business newspapers and magazines,” which indiscriminately “cover any transactions deemed

\(^{2527}\) Ibid., 7-8.
\(^{2528}\) Ibid., 8.
\(^{2529}\) Frank Partnoy, “The Paradox of Credit Ratings,” 19.
newsworthy,” Fitch “only ‘covers’ its own clients,” that is, those clients that hire them.\textsuperscript{2531} Second, Fitch was found to have had an unusually high “level of involvement” with the clients that had hired them, one that is “not typical of the relationship between a journalist and the activities upon which the journalist reports.”\textsuperscript{2532}

With the three largest NRSRO’s finding themselves “besieged in courts,”\textsuperscript{2533} the extent of their responsibility in contributing to the subprime mortgage crisis should become more apparent in the near future. An example of a recent lawsuit includes the Teamsters Local 292 Pension Trust Fund filing of a securities class action suit against Moody’s Investors Services. The plaintiff alleges that “Moody’s failed to disclose that it assigned excessively high ratings to securities backed by risky subprime mortgages.”\textsuperscript{2534} What is intriguing about this suit is that the plaintiff is actually a shareholder of Moody’s as opposed to an investor who relied upon credit ratings. Moody’s “excessively high” ratings of subprime mortgage-backed securities led to an increase in Moody’s stock price, but as those securities began to be downgraded, the stock price fell. Teamsters Local 292 Pension Trust Fund is seeking “redress under sections 10(b) and 20(a) of the Securities Exchange Act of 1934.”\textsuperscript{2535} The Indiana Laborers Pension Fund has filed a similar suit against Fimalac, the parent company of Fitch Ratings. The plaintiff involved in this July 1, 2008 class action suit accuses Fimalac of applying “low standards or no standards” when it came to rating mortgage-backed securities. The high ratings that were made possible by lax standards generated more business for Fimalac, “which boosted [their]...
earnings… and artificially inflated its stock.” Like the Teamsters Local 292 Pension Trust Fund, the Indiana Laborers Pension Fund claims that Fimalac “violated sections 10(b) and 20(a) of the Securities Exchange Act of 1934.” Decisions have not yet been reached on these two more recent lawsuits, though they are part of the influx of litigation that the three largest NRSRO’s are currently encountering.

One could argue that the legal immunization from liability that the three largest NRSRO’s experienced during and leading up to the subprime mortgage crisis could have contributed to conditions that were conducive to both group and general bias. With little (perceived) legal accountability, those NRSRO’s may have adopted more profitable, though riskier, practices since it would be the investors, the users of the ratings, who would bear the majority of the short-term costs of those practices. Power without accountability can give one the ability to have others shoulder a disproportionately large share of the downsides of risky behavior, while simultaneously ensuring oneself a share of the potential benefits resulting from such behavior. The three largest NRSRO’s and their primary customers, the arrangers, could profit from this arrangement, while casting the risks associated with misleading ratings off on other related parties.

Absent any real or perceived legal accountability, what measures or forces exist to check the conduct of the three largest NRSRO’s and make them more responsible for their practices? The standard answer is that the NRSRO’s are restrained by their deep concern over the state of their reputations. Aside from violating securities laws or engaging in other illegal activities, a NRSRO’s reputation can supposedly be tarnished in

\[\text{\scriptsize 2536 Ibid.}\]
\[\text{\scriptsize 2537 Ibid.}\]
\[\text{\scriptsize 2538 For example, see the statement by Deven Sharma, President of Standard and Poor’s, that he contributed to the SEC’s April 15, 2009 “Roundtable to Examine Oversight of Credit Rating Agencies” available at http://www.sec.gov/comments/4-579/4-579.shtml, 7.}\]
two ways: (1) if they violate their own publicly available policies, procedures, and codes of conduct (how they arrived at their ratings) or (2) if they gain a reputation for producing shoddy or inaccurate ratings (what those ratings are). I will consider the plausibility of both of these apparent reputation-based concerns in turn.

In an effort to begin to explore whether the NRSRO’s have a strong incentive to adhere to their own published policies, procedures, and codes of conduct, it would perhaps be helpful to consider a highly publicized exchange between two officials in Standard and Poor’s structured finance division, one in which they were discussing whether they should move forward with rating a particular deal. Here is a portion of the April 5, 2007 exchange:

Official One: That deal is ridiculous.
Official Two: I know, right. The model definitely doesn’t capture half the risk.
Official One: We should not be rating it.
Official Two: We rate every deal. It could be structured by cows and we would rate it.
Official One: But there is a lot of risk associated with it – I personally don’t feel comfy signing off as a committee member.2539

Regardless of whether the model that the officials were speaking of was the arranger’s model or Standard and Poor’s, the crucial points are that the employees felt pressured to rate products that they thought had a significant amount of real, though ignored, risk attached to them and, further, that they thought it was somewhat of a norm at Standard and Poor’s to rate such products anyway, since they “rated every deal,” even if “structured by cows.”

At Moody’s, evidence surfaced that suggested they were assigning credit ratings to products without even completely understanding them. A crucial component of

assessing credit risk is discerning the recovery rate, or the amount that a creditor would
recover in the event that a debtor defaults on its obligations.2540 As mentioned before,
according to Moody’s “Code of Professional Conduct,” part of what informs their ratings
is, in fact, the recovery rate or “the likelihood of default on a bond and the estimated
severity of loss in the event of that bond’s default.”2541 Yet, a Moody’s document was
discovered that “addresses the question of [the] weighted average recovery rate” of “an
outstanding issue” by writing, “WARR – don’t ask 😊.”2542 Presumably, the reason that it
was requested that one should not ask about the weighted average recovery rate of the
issue was because the issue itself was too complex and, consequently, resistant to such a
measurement.

The three largest NRSRO’s would certainly be acting irresponsibly if they elected
to rate a complex financial product after making the prior judgment that the quality of the
product was indecipherable or misrepresented. Setting aside for a moment the question as
to why the NRSRO’s would choose to act in such a way, it is important to note that
Moody’s and Standard and Poor’s very own respective policies, procedures, and codes of
conduct permit them to “rate every deal.” Although Moody’s claims that it “will refrain
from providing a Credit Rating unless it believes that it has sufficient information and
analytical expertise to do so,”2543 they also maintain that they have “no obligation to

2541 Code of Professional Conduct, 2. Italics mine.
2542 United States Securities and Exchange Commission, “Summary Report of Issues Identified in the
Commission Staff’s Examinations of Select Credit Rating Agencies,” (July 2008), available at
www.sec.gov/news/studies/2008/craexamination070808.pdf, 12. For the insight that the “select” credit
rating agency in this example was Moody’s, please see Aaron Lucchetti, “S&P Email: ‘We Should Not Be
Rating It,’” The Wall Street Journal (August 2, 2008), available at
2543 Code of Professional Conduct, 8. The codes of conduct of Fitch and Standard and Poor’s contain
similar claims. See Fitch Ratings Code of Conduct, 4-5; Rating Services Code of Conduct, 5.
perform, and does not perform, due diligence with respect to the accuracy of [the] information it receives or obtains in connection with the rating process. When taken together, this is an astounding disclaimer. Essentially, Moody’s is placing itself on “the honor system,” affirming that they will only rate deals if the arranger has supplied them with “sufficient information,” while, at the same, refusing to take responsibility for determining whether that information is accurate or not. What if the arranger-supplied information is considered to be sufficient for making a rating judgment, but the information upon which the judgment is being made is inaccurate?

Standard and Poor’s “Rating Services Code of Conduct” essentially contains the same disclaimer, adding that they rely on the arranger, “its accountants, counsel, advisors, and other experts for the accuracy, completeness, and timeliness of the information submitted” to them. To their credit, Fitch recently released a report titled “Ensuring Reliability and Transparency in the Rating Process” in which they declared that they have “strengthened [their] structured finance originator evaluations,” requiring that “loan level reviews must be conducted by an independent third party to better identify poor underwriting practices.” Nevertheless, there is a section in their “Ratings Code of Conduct” that is titled “What Fitch Expects of Issuers.” Part of these expectations is that each arranger “will promptly supply Fitch all information relevant to evaluating the ratings” and that “all such information [will] be timely, accurate and complete in all respects.” Prior to the February 2009 publication of “Ensuring Reliability and Transparency in the Rating Process,” it is likely that Fitch had the same

2544 Ibid., 6.
2545 Rating Services Code of Conduct, 4.
2547 Fitch Ratings Code of Conduct, 15-16.
posture towards performing due diligence on the loan-level information as Moody’s and Standard and Poor’s.

One may argue, like the Managing Director of Standard and Poor’s, Richard Gugliada, that “any request for loan level tapes is TOTALLY UNREASONABLE” from the perspective of the NRSRO’s. 2548 A single mortgage-backed security may contain as many as 25,000 mortgage loans, 2549 and collateralized debt obligations may contain numerous mortgage-backed securities (along with other kinds of debt instruments). Perhaps it was not possible, therefore, for the three largest NRSRO’s to perform due diligence on the quality of the loan-level mortgage information that they were using to rate mortgage-backed securities. Rather, it could be contended that the responsibility for performing such due diligence falls upon the arranger, as Standard and Poor’s “Rating Services Code of Conduct” states.

If this argument has any merit, the new question that emerges is whether Moody’s, Standard and Poor’s, and Fitch demanded that the arrangers of the mortgage-backed securities perform due diligence at the level of loan origination. A July 2008 report published by the SEC, the product of examining those NRSRO’s for approximately ten months, 2550 clearly demonstrates that they did not make such demands on the arrangers. The SEC found that NRSRO’s were not required to insist that arrangers

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2548 Henry A. Waxman, “Opening Statement: Credit Rating Agencies and the Financial Crisis,” 7. In this context, Gugliada was emphatically responding to a request from a Standard and Poor’s employee, Frank Raiter, who wanted access to collateral tapes so he could evaluate the credit risk of the underlying mortgage loans backing a collateralized debt obligation.


“perform due diligence, and they [were] not required to obtain reports concerning the level of due diligence” performed by arrangers.\textsuperscript{2551}

What has been established so far in this section is that the three largest NRSRO’s policies, procedures, and codes of conduct (1) did not require them to perform due diligence on the loan-level information that they were relying upon to generate their ratings of mortgage-backed securities; (2) did not require them to demand that the arrangers of the mortgage-backed securities perform due diligence on that same information; (3) permitted them to use their own discretion as to whether the arranger-supplied information was sufficient enough to make a credit rating judgment. Of course, the quality of a credit rating depends, in large part, upon the quality of the information used in making a rating judgment. If the underlying, loan-level information is false or incomplete, then the ratings that are constructed on the basis of that information will likely be inaccurate, no matter how flawless the risk model used in processing the information turns out to be. Perhaps anticipating such a concern, Fitch’s “Ratings Code of Conduct” contains the remarkable warning that its ratings “are not themselves facts and therefore cannot be described as being ‘accurate’ or ‘inaccurate.’”\textsuperscript{2552}

The pivotal question, therefore, is whether the concern over gaining a reputation for publishing inaccurate ratings was a powerful enough incentive to dissuade the three largest NRSRO’s from making rating judgments on mortgage-backed securities on occasions where the arranger supplied inadequate loan-level information. This question is a particularly pressing one because their own published policies, procedures, and codes of conduct do not appear to take any measures to discourage them from moving forward

\textsuperscript{2551} Ibid., 17.  
\textsuperscript{2552} Fitch Ratings Code of Conduct, 16.
with making rating judgments on those occasions, beyond placing them on a self-policing “honor system.” Those manuals reveal that it is up to each NRSRO to assess whether the arranger-supplied information is “sufficient” for producing a credit rating. What if it is profitable, though, to produce a credit rating even when the information upon which the rating is based is insufficient? Does the incentive of preserving a reputation for issuing accurate credit ratings outweigh the incentive to make money, should the two be in conflict with one another?

During the nascent stage of credit ratings, prior to the Great Depression, it was noted that a credit rating agency’s reputation was, indeed, held by them to be of inestimable value. However, it will be argued that the confluence of two crucial factors created conditions in which “the road to profit” for the NRSRO’s no longer had to “pass through” the confines of maintaining a reputation for publishing accurate credit ratings. The first factor was that there was a government-mandated demand for credit ratings, accompanied by government-enforced restriction on the suppliers of those credit ratings. Second, the credit rating industry’s shift away from the investor-pays model and the subsequent adoption of the arranger-pays model in the early 1970’s gave rise to a business model in which the primary users of credit ratings were no longer the ones compensating those providing the credit ratings. Incidentally, the NRSRO’s were forced to grapple with an unprecedented conflict of interest between satisfying the demands of their paying customers and fulfilling their role as publishers of accurate credit ratings. Both of these factors will now be explored in greater detail.

The government-mandated demand for credit ratings began, as discussed before, after the Great Depression. The 1936 decree issued by the Comptroller of the Currency
was one that was intended “to encourage banks to invest only in safe bonds,” prohibiting them from investing in “‘speculative investment securities’ as determined by ‘recognized rating manuals’.” Lawrence White, a professor of economics at the New York University Stern School of Business, maintains that “[t]his regulatory action importantly changed the dynamic of the bond information market,” for the banks “were no longer free to act on information about bonds from any source that they deemed reliable.” At the same time, the government “outsourced… to the rating agencies their safety judgments about bonds that were suitable for banks’ portfolios,” bestowing upon those safety judgments “the force of the law.”

The government-enforced restriction on the supply of credit ratings culminated in the SEC’s creation of the NRSRO category, declaring that “only the ratings of NRSRO’s were valid for the determination of the broker-dealers’ capital requirements” as specified by the Net Capital Rule. Partnoy argues that, since 1975, the term “NRSRO” is involved in a “web of regulation… so thick that a thorough review would occupy hundreds, perhaps thousands, of pages.” To substantiate this point, Partnoy performed a LEXIS-NEXIS database search for NRSRO citations and discovered that in securities regulation alone, the term was cited over 1,000 times. Another report found that

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2554 Ibid.
2555 Ibid.
2556 Ibid., 4.
2558 Ibid. The search was performed in 1999.
“NRSRO usage requirements” have been included in “at least 8 Federal statutes, 41 regulations, and over 100 state acts and regulations.”

By giving credit ratings the force of law and, later, limiting which credit ratings could actually have that force, the government arguably helped loosen the shackles of reputational considerations that previously restrained the NRSRO’s. One can imagine the heightened status that Consumer Reports ratings would assume, if the United States government legally required all citizens to buy only highly rated consumer appliances, and further indicated that only Consumer Reports and a few other rating organizations were fit for determining what is a highly rated appliance and what is not. It is reasonable to posit that, in such a scenario, Consumer Reports would suddenly sell more subscriptions to their magazine than they previously had, regardless of whether they maintained a reputation for publishing accurate ratings. Referring back to the credit rating industry, it should come as no surprise that “Moody’s, S&P, and Fitch produce about 98% of all ratings and earn 94% of all ratings revenue.” Moody’s, in particular, saw its profits quadruple between 2000 and 2007, while maintaining “the highest profit margin of any company in the S&P 500 for five consecutive years.”

Partnoy persuasively argues that the role of the three largest NRSRO’s has shifted from one of selling information about credit risk to one of selling regulatory licenses. By a “regulatory license,” Partnoy means “a permit to participate in some regulatory activity,” not unlike a driver’s license permits an individual to participate in the regulated

2561 Ibid., 1.
activity of operating an automobile.\textsuperscript{2563} Whereas the buyer of a driver’s license pays for a permit to drive a car, the buyer of a mortgage-backed security credit rating, the arranger, pays for a “permit” to have that security attract investor funds. The “dysfunctional result” of this shift has been one in which market participants inordinately depend upon credit ratings, while Moody’s, Standard and Poor’s, and Fitch were “no longer constrained by reputation.”\textsuperscript{2564} Partnoy elaborates on this claim by adding:

\begin{quote}
[The three largest NRSRO’s] can issue low quality ratings, but market participants will still pay for them. Indeed, they must pay for them, because of regulations that depend on ratings. Without a rating, many issuers will be locked out of the markets.\textsuperscript{2565}
\end{quote}

In sum, due to the fact that credit ratings are “embedded in a web of U.S. regulations and laws”\textsuperscript{2566} and that the SEC has given three of the suppliers of those credit ratings a tremendous competitive advantage, the “pull” of the incentive for preserving a reputation for publishing accurate ratings has likely weakened.

The second factor that has likely diminished the three largest NRSRO’s concern over their reputation for producing accurate ratings can be found in the arranger-pays business model that emerged in the early 1970’s. It was noted in passing that the shift from the investor-pays model to the arranger-pays model may well have been for the sake of overcoming a free-rider problem that arose from the advent of low-cost photocopying technology during that time. Another possible explanation is that the bankruptcy of Penn Central Railroad, an arranger, in 1970 “shocked the bond markets” and made arrangers “more conscious of the need to assure bond investors that they really were low risk, and

\textsuperscript{2564} Ibid.
\textsuperscript{2565} Ibid.
\textsuperscript{2566} James H. Gellert and Patrick James Caragata, “SEC Roundtable Oversight of Credit Rating Agencies: Competition in the Credit Rating Industry,” 3.
that they were willing to pay the credit rating firms for the opportunity to have the latter vouch for them." Lawrence White contends that the “reasons for this change of business model have not been established definitively.”

The main change that the arranger-pays model brought about was that the investors who were using the ratings to inform their investment decisions were no longer the ones compensating the NRSRO’s for their work. Instead, the arranger began to pay the NRSRO’s to determine the credit risk associated with “a credit commitment, a debt or debt-like security,” or even the arranger itself of such obligations. A common criticism though is that this “business model appears to generate a pervasive conflict of interest that benefits arrangers at the expense of investors as the agencies inflate ratings to curry favor with paying customers.” In other words, it is an arrangement that is hospitable to group bias. How do arrangers benefit at the expense of investors and why would the NRSRO’s willingly inflate their ratings?

In response to the first part of that question, it is important to point out that an arranger’s ability to raise capital heavily depends upon the rating that they receive on their debt from the NRSRO’s. Receiving a high credit rating enables an arranger to offer its debt at a lower interest rate because it has been deemed, justifiably or not, to be on the safer side of the risk spectrum. As Standard and Poor’s rating scale explains, an obligation rated “AAA” signifies that, in their opinion, the “obligor’s capacity to meet its financial commitment on the obligation is extremely strong.” An arranger whose bond

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2568 Ibid.
2569 Code of Professional Conduct, 4.
is rated “AAA” can, because of the lower apparent risk, offer that bond at a lower interest rate to investors. Paying lower interest rates on their bonds leaves arrangers with a greater spread for themselves. 2572 In other words, the higher the rating an arranger receives on its debt, the more cheaply that same arranger can raise capital.

The arrangers’ preoccupation with high ratings once the arranger-pays model came into being was not a new development.2573 What was a new development was the extent to which arrangers were able to influence the NRSRO’s ratings since they, unlike the investors, were now the paying customers. The well-chronicled difficulty that the NRSRO’s faced was that they had to serve two masters: (1) the arrangers who wanted high ratings and were now their source of revenue and (2) the investors, who were still relying on them to publish reliable and accurate ratings. Arrangers that were displeased with the preliminary rating that an NRSRO gave to one of their bonds could simply “shop” the bond around to be rated by one or both of the other NRSRO’s. The incentive structure that was now in place was for NRSRO’s to inflate their ratings (satisfying the desires of their paying customers), for they would otherwise lose market share to more “accommodating” competitors.

A May 25, 2004 e-mail from a Managing Director at Standard and Poor’s, with the subject of “Competition with Moody’s,” voiced concern over how they “just lost a huge Mizuho RMBS deal to Moody’s due to a huge difference in the required credit level.”2574 The Managing Director learned from the arranger of the residential mortgage-backed security, the Japanese “mega bank” Mizuho, that the credit support level at

Standard and Poor’s “was at least 10% higher than Moody’s” enabling the latter to rate the security higher (less riskier) than the former. Losing deals to competing NRSRO’s because of “criteria issues” was, according to this employee, “so significant that… [S&P] need[s] to address this now in preparation for the future deals.”

Similarly, a March 21, 2007 e-mail from a Managing Director at Moody’s called attention to how he heard that Fitch had “approached [arrangers] and made the case to remove Moody’s from their deals and have Fitch rate the deals [instead]” because of “the firm position” that Moody’s had taken with respect to haircuts. When a NRSRO is evaluating the underlying value of a mortgage-backed security and arrives at the judgment that its value is uncertain, the NRSRO may require a haircut, or additional collateral, in order to give the security a particular, higher rating. The idea is that the haircut will compensate for the uncertainties associated with the underlying value of the security. The Managing Director at Moody’s is suggesting in the e-mail that they had “lost several deals” to Fitch because of their respective position on haircuts. Whereas Moody’s had been promoting haircuts for “about 6 years,” Fitch had been privately arguing that haircuts “are not good and that managers should be allowed [to have] ultimate flexibility.” The perception, then, that this Managing Director at Moody’s had of Fitch was that they value contouring their ratings to the needs of arrangers over producing ratings that accurately convey credit risk. Furthermore, he believed that Fitch’s more lenient methodologies for assessing credit risk were steering business away from

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2575 Ibid.
2576 Ibid.
2578 Ibid.
2579 Ibid.
Moody’s. NRSRO’s that attempted to produce accurate credit ratings were being penalized for not being as “flexible” as their competitors.

The arranger’s ability to “rate shop” likely resulted in putting pressure on the three largest NRSRO’s to sacrifice the quality of their ratings for the sake of generating ratings that were as high as possible. Implicit in this incentive structure is the primacy of the desire for profit over the desire for a reputation for publishing accurate ratings, let alone any concern for potential ripple effects that misleading ratings could eventuate. One could also make the case that the lack of competition in the credit rating business enabled the three largest NRSRO’s to “coast” on the momentum brought about by brand recognition, which, itself, was made possible by historical performance and simply being in the market longer than other credit rating agencies. With a storehouse of goodwill already intact and protection from competition under the auspices of the NRSRO designation, perhaps Moody’s, Standard and Poor’s, and Fitch decided that the benefits of inflating their ratings outweighed the potential costs that those ratings would carry with them. The immediacy and certainty of profit may have had a pull that was stronger than the repelling force of having one’s reputation tarnished in the future. The “lag” in being able to assess the accuracy of a credit rating may have encouraged the three largest NRSRO’s to privilege the former over the latter to an even greater degree. With these conditions in place, one can posit that those NRSRO’s likely succumbed to the temptations afforded by group and general bias.
5.6. Conclusion

The central argument in this section is that Moody’s, Standard and Poor’s, and Fitch were, especially around the turn of the century, in a position where they could act in a short-sighted, though profitable, fashion without burdening themselves with any imminent, negative consequences. Or, as stated by an analyst at Standard and Poor’s in a December 15, 2006 e-mail, “Let’s hope that we are all wealthy and retired by the time this house of cards falters.” In a 2009 op-ed piece in The New York Times, authors Michael Lewis and David Einhorn maintain that the three NRSRO’s “didn’t simply miss a few calls here and there,” rather, in “pursuit of their own short-term earnings,” they did “exactly the opposite of what they were meant to do.” As opposed to exposing financial risk, the two authors contend that the three NRSRO’s “systemically disguised it.” One set of analysts determined that, by 2010, over 90% of the mortgage-backed securities rated AAA (Aaa) by Standard and Poor’s and Moody’s in 2006 and

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2580 As of October of 2012, the SEC has not filed a single lawsuit against Standard and Poor’s, Moody’s, or Fitch for their role in the subprime mortgage crisis. Astonishingly, as William Cohan noted, the SEC has, however, filed an administrative proceeding against the lone NSRSO that is paid by investors instead of arrangers: Egan-Jones Ratings Company. As Cohan explains, the SEC claims that Egan-Jones “falsely stated” that it had already rated the credit of 150 asset-backed securities and of 50 sovereign-debt issues… [and that it] “willfully made these misstatements and omissions to conceal the fact that it had no experience issuing ratings on ABS or government issuers.” Please see: William D. Cohan, “SEC Sues the One Ratings Firm Not on Wall Street’s Take,” Bloomberg News (September 30, 2012), available at http://www.bloomberg.com/news/2012-09-30/sec-sues-the-one-rating-firm-not-on-wall-street-s-take.html. In response to this administrative proceeding Egan-Jones declared, that it is “the latest in a series of SEC actions which are designed to diminish and marginalize Egan-Jones while supporting and maintaining the status quo of an issuer-paid ratings agency monopoly.” Please see: Joshua Gallu and Edvard Pettersson, “Egan-Jones Sues to Have SEC Allegations Tried in Federal Court,” Bloomberg News (June 7, 2012), available at http://www.bloomberg.com/news/2012-06-07/egan-jones-sues-to-have-sec-allegations-tried-in-federal-court.html.


2583 Ibid.
2007 were downgraded to junk status. The Chairman of the Financial Crisis Inquiry Commission, Phil Angelides, called Moody’s “a triple-A factory,” citing how the company “slapped its coveted triple-A rating on 42,625 residential mortgage-backed securities” from 2000-2007. The CEO of Moody’s, Raymond McDaniel, conceded that the company’s performance with respect to rating United States residential MBSs and CDOs during the 2000’s was “deeply disappointing.”

Believed to be exempt from any legal repercussions for their published ratings and, in all likelihood, having a muted concern over the future state of their reputations, the three largest NRSRO’s had a compelling set of incentives to engage in excessively risky behaviors, while also facing a dearth of liabilities to hold them accountable for those behaviors. One of the main ways that they contributed to the subprime mortgage crisis is that they helped make subprime mortgage-backed securities appear to be reasonable investments to the investment community. A high rating for those securities was a key ingredient in creating a high demand for them. In exchange for this disservice, they were compensated by the arrangers who paid them to produce these flawed ratings. Subsequently, one may be apt to agree with Sean Egan, Managing Director of Egan-Jones Rating Company, who stated that the three largest NRSRO’s ratings “were a major factor in the most extensive and possibly expensive calamity in recent American

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Moody’s, Standard and Poor’s, and Fitch, in other words, were indispensable players in the painful breakdown of the good of order that has been labeled the subprime mortgage crisis.

\footnote{Sean J. Egan, “Testimony Before the House Committee on Oversight and Government Reform,” (October 22, 2008), \textit{available at} http://oversight.house.gov/story.asp?ID=2250, 1.}
Chapter Six

6.0. The Housing GSEs: Fannie Mae and Freddie Mac

6.1. Introduction

Any account of the subprime mortgage crisis would be incomplete without an explanation of how the two housing government sponsored enterprises (GSEs), Fannie Mae and Freddie Mac, contributed to it. The first section of this long chapter presents a brief history of the two housing GSEs, while the second section explains what the term “GSE” means. Next, I will describe how Fannie Mae and Freddie Mac were the recipients of a unique and multifaceted federal subsidy that enabled them to serve as a magnet for investor funds. I will then discuss their two primary lines of business and how one is riskier and more profitable than the other. After providing an account of how their reputations were tarnished in the early 2000’s, I will argue that despite the fact that Congress, at that point, should have strengthened its regulatory oversight of Fannie Mae and Freddie Mac, it failed to do so for a few key reasons. The remaining sections of the chapter chronicle the collapse of the two housing GSEs and outline the factors that contributed to their respective downfalls.

6.2. A Brief History of Fannie Mae and Freddie Mac

Title III of the National Housing Act of 1934 provided for the chartering of Fannie Mae, which was originally called the National Mortgage Association of Washington. Officially, the National Mortgage Association of Washington was chartered on February 10, 1938 and, later that same year, the institution’s name changed to the Federal National Mortgage Association (Fannie Mae). Two of the primary reasons that
Fannie Mae was created were to demonstrate that Congress had “a national commitment” to American homeownership and to address the fact that, in the wake of the Great Depression, private lenders were either unable or unwilling to “ensure a reliable supply of mortgage credit throughout the country.”\textsuperscript{2588} As David Wheelock notes, between 1929 and 1933 “U.S. personal income declined by 44 percent, real output fell by 30 percent, and the unemployment rate climbed to 25 percent of the labor force.”\textsuperscript{2589} The number of housing foreclosures during this period increased from 134,900 in 1929 to 252,400 in 1933, while “as many as half of urban home mortgages were delinquent on January 1, 1934.”\textsuperscript{2590} The combination of rampant unemployment, a substantial decrease in personal income, and a decline in housing prices took a heavy toll on private lending institutions and made them reluctant to “tie up their funds in illiquid long-term mortgages.”\textsuperscript{2591}

Two of the original purposes of Fannie Mae, according to its charter, were to “provide stability in the secondary mortgage market for residential mortgages” as well as to “promote access to mortgage credit throughout the Nation (including central cities, rural areas, and underserved areas) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing.”\textsuperscript{2592} Assuming that private lending institutions in the primary market, the market dealing directly with originating mortgages, adopted loaning practices that

\begin{itemize}
  \item \textsuperscript{2588} Fannie Mae, “About Fannie Mae” available at http://www.fanniemae.com/aboutfm/charter.jhtml?p=About+Fannie+Mae.
  \item \textsuperscript{2590} Ibid.
\end{itemize}

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conformed to the guidelines established by the Federal Housing Administration, those institutions could then sell their originated mortgages on the secondary market to Fannie Mae. Confident that they could “easily turn these mortgages into cash if they needed to,” these private lending institutions would have more of an incentive to extend mortgage credit.\textsuperscript{2593} Thus, one reason why Fannie Mae was created was to establish a mechanism for transferring the credit risk that home borrowers would not pay back the principal amount that they borrowed plus interest away from private lenders on the primary market.

A second reason that Fannie Mae was invented was to “smooth out discrepancies between capital-rich and capital-poor regions of the country” with respect to financing residential mortgages.\textsuperscript{2594} By issuing bonds, Fannie Mae could serve as an intermediary between investors purchasing the bonds and those borrowers seeking conforming home mortgages, effectively creating “channels” for flows of capital that were previously unavailable due to geographical separation. Prior to the advent of Fannie Mae, lenders on the primary market were limited in the number of mortgage loans that they could finance by the amount of the cash deposits of their customers. Additionally, federal law forbade interstate banking, which necessarily limited the size of banks. Fannie Mae, on the other hand, had access to investor capital across the United States and could buy lender-originated conforming mortgages nationwide.

In 1954, Title III of The National Housing Act of 1934 was revised. Instead of being a pure federal government agency, Fannie Mae was converted into a mixed-ownership corporation by The Federal National Mortgage Association Charter Act of

\begin{footnotes}
\item[2594] Ibid.
\end{footnotes}
1954. In an important sense, The Charter Act of 1954 provided “the basic framework under which Fannie Mae operates today,” for it attempted to accommodate both government and private investor control.\textsuperscript{2595} It stipulated that the federal government would hold Fannie Mae’s preferred stock, while its common stock would be privately held. The Charter Act of 1954 also exempted Fannie Mae from all local taxes except property taxes.\textsuperscript{2596}

The next key development in Fannie Mae’s structure occurred in 1968. The revolutionary Charter Act of 1968 split Fannie Mae into two separate corporations. One corporation was named The Government National Mortgage Association (Ginnie Mae) and the other retained the name The Federal National Mortgage Association (Fannie Mae). Ginnie Mae became an agency within the Department of Housing and Urban Development and began to guarantee mortgage-backed securities that had as their assets residential mortgages that were insured primarily by the FHA or by the Department of Veterans Affairs (formerly the Veterans Administration or VA).\textsuperscript{2597} Fannie Mae, on the other hand, became a Government-Sponsored Enterprise (GSE), a unique, hybrid entity that is both privately owned, yet federally chartered.

Before discussing what a GSE is in greater detail, it is helpful to briefly note why Congress and the Lyndon Johnson administration invented the GSE structure in the first place and decided to transform Fannie Mae into a housing GSE. As Peter Wallison and Charles Calomiris explain, “In seeking to reduce the budget deficits associated with the Vietnam War and the Great Society programs, the [Johnson] administration hit upon the

\textsuperscript{2595} Ibid.
\textsuperscript{2596} Ibid.
idea of ‘privatizing’ Fannie Mae by allowing the company to sell shares to the public.”

By becoming a GSE, Fannie Mae would be able to continue its activities of funding residential mortgages on the secondary market, while simultaneously taking the costs associated with those activities off of the federal budget. In other words, in designating Fannie Mae a GSE, the federal government was able to both appear to be committed to the value of American homeownership, while having a significant portion of the costs accompanying that commitment financed by a different source.

Two years later, Congress created the Federal Home Loan Mortgage Corporation (Freddie Mac), the other major housing GSE, by passing the Emergency Home Finance Act of 1970. In an effort to support the crippled mortgage markets at the time, Congress made Freddie Mac responsible for securitizing mortgages that were originated by savings and loans associations. Freddie Mac was a private, though not publicly traded, company throughout the 1970s and 1980s “with its equity shares held solely by the twelve Federal Home Loan Banks (FHLBs) and by the S&Ls that were members of the FHLBS.” What primarily differentiated Freddie Mac from Fannie Mae during this period was that Freddie Mac tended to securitize mortgages, originated mostly by the savings and loan associations, whereas Fannie Mae tended to hold mortgages in its own portfolio that it had bought predominantly from mortgage banks. In 1989, Freddie Mac was converted into a publicly traded company, a decision anchored in the belief that

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2599 Ibid.
2601 Ibid.
2602 Ibid.
“a wider potential shareholding public would raise the price of the shares held by the then
ailing S&L industry and thus improve the balance sheets of the latter.”

6.3. What Does It Mean To Call Fannie Mae and Freddie Mac a Housing
GSE?

If Fannie Mae and Freddie Mac, as housing GSEs, are not quite private sector
companies, yet not exactly government agencies, precisely what are they? Perhaps the
best place to begin answering this question is to mention that Fannie Mae and Freddie
Mac are instrumentalities of the federal government. As instrumentalities, they are
organizations “that carry out public purposes, but are not part of the government
itself.” In fact, they share attributes of both private companies and government
agencies. Like many other private companies, the two housing GSEs trade issues of stock
on the New York Stock Exchange. They are “operated by private owners and
managers.” Their officers and employees “can earn compensation comparable to that
of other financial institutions of similar size,” and those individuals do not work for the
federal government. They pay federal income taxes as though they were private
companies. Finally, one of their purposes, as investor-owned companies, is to make
profits for their shareholders. The 1919 Michigan Supreme Court case, Dodge v Ford
Motor Company, “established that an investor-owned company may not divert significant

2603 Ibid.
2604 Thomas Stanton, Government-Sponsored Enterprises: Mercantilist Companies in the Modern World
2605 Ibid., 17.
2606 Ibid., 22.
2607 Ibid.
amounts of the shareholders’ money to purposes other than profitable activities.”\(^{2608}\) The implications of this last point will be examined in a later section.

Fannie Mae and Freddie Mac are also similar to federal government agencies. They are “exempt, in general, from state and local income taxation”\(^{2609}\) and they “generally need not register or obtain a license in the states where [they] may do business.”\(^{2610}\) They may only engage in activities “that they are expressly authorized to carry out or that are incidental to their otherwise authorized activities.”\(^{2611}\) Their charters specify identical “authorized” activities. First, they are to provide stability in and ongoing assistance to the secondary market for residential mortgages, including “activities relating to mortgages on housing for low and moderate-income families.”\(^{2612}\) Second, they are required to increase “the liquidity of mortgage investments” and improve “the distribution of investment capital available for residential mortgage financing.”\(^{2613}\)

### 6.4. The Importance of the Implicit Federal Government Guarantee and Subsidy

Looking back, one of the more perplexing consequences that emerged out of the unusual structure of the two housing GSEs was that their debt obligations came to be commonly acknowledged\(^{2614}\) as being implicitly guaranteed by the federal government.

\(^{2608}\) Ibid., 79.
\(^{2609}\) Ibid., 23.
\(^{2610}\) Ibid., 20.
\(^{2611}\) Ibid.
\(^{2613}\) Ibid.
On the surface, it appears to have been unreasonable to assume that the federal government would “come to the rescue” of Fannie Mae or Freddie Mac in the event that either of them were threatened by failure.\textsuperscript{2615} Within a Fannie Mae prospectus, one will find the following disclosure: “The Certificates, together with interest thereon, are not guaranteed by the United States. The obligations of Fannie Mae are obligations solely of the corporation and do not constitute an obligation of the United States or any agency or any instrumentality thereof other than the corporation.”\textsuperscript{2616} On what grounds, then, could one have presumed that the United States federal government backed the two housing GSEs’ debt obligations?

One potential reason was that there has been a precedent for a GSE receiving federal aid in a time of crisis. During the farming financial crisis, which took place in the middle of the 1980’s, the federal government ended up providing the Farm Credit System with $4 billion in aid.\textsuperscript{2617} Since one GSE had already received assistance from the federal government during a period of financial hardship, perhaps one could have reasonably anticipated that the two housing GSEs would, likewise, receive federal aid should the need for it arise.

A more compelling reason for believing that the federal government backed Fannie Mae and Freddie Mac’s debt obligations was that Fannie Mae itself had already been the beneficiary of government assistance in the early 1980’s when interest rates


sharply rose and the housing GSE could not cover the cost of its debt. In 1981, Fannie Mae had a negative net worth of almost $11 billion and suffered “cumulative net losses of over $350 million in 1981, 1982, 1984, and 1985.” The important point is that, in response to the housing GSE’s financial difficulties, “Congress passed a law that extended Fannie Mae’s tax loss carryback period,” a benefit that was later appraised to be worth $25 million. As a 1990 United States General Accounting Office report points out, Congress was not legally obligated to pass this law. One should also note that throughout this period of financial stress, Fannie Mae “retained the highest credit rating possible” and was able to borrow $31 billion in long-term debt and $64 billion in short-term debt “with only a brief increase in its borrowing costs.” The same report maintains that any other wholly private firm, under these circumstances, would “typically be blocked from borrowing or would be permitted to borrow only at extremely high rates of interest.”

Third, Fannie Mae and Freddie Mac’s debt obligations received favorable treatment from the three largest credit rating agencies, Moody’s, Standard and Poor’s, and Fitch. Those credit rating agencies bestowed a special status upon the two housing GSEs’ debt obligations, labeling them “U.S. agency securities.” This rating was so high that it was superior to all AAA-rated corporate debt and just below United States

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2621 Ibid.
2622 Ibid.
2623 Ibid.
2624 Ibid.
Treasury bonds. Clearly, the basis for this high rating stemmed from the implied federal government guarantee of the two housing GSEs’ debt obligations, creating the perception that those obligations are safer than even those of the four remaining AAA-rated companies, Automatic Data Processing, Johnson & Johnson, Exxon Mobil, and Microsoft. One should keep in mind those three rating agencies’ definitions of an AAA rating. For Moody’s, an Aaa rating is an assessment that the obligations “are judged to be of the highest quality, with minimal credit risk.” For Standard and Poor’s, an AAA rating is its “highest rating,” representing an “extremely strong capacity to meet financial commitments.” As for Fitch, an AAA rating is “only assigned in cases of exceptionally strong capacity for payment of financial commitments” and denotes “the lowest expectation of default risk.” In granting the two housing GSEs’ debt obligations a rating above even an AAA rating, the perception was promulgated that the United States government will not permit Fannie Mae and Freddie to default on those obligations.

Fourth, one could simply look at the unusual relationship that the two housing GSEs have with the federal government to arrive at the conclusion that the latter stands behind the obligations of the former. John Weicher describes this relationship as one that possesses an “Elizabethan character,” in the sense that the federal government “has conferred broad privileges on the GSEs” similar to how “sovereigns gave personal

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2625 Moody’s Investors Service, “Moody’s Rating Symbols & Definitions,” (August, 2003), available at http://www.rbcpa.com/Moody%27s_ratings_and_definitions.pdf, 6. Please note that Moody’s ratings consist of one uppercase letter potentially followed by one or two lowercase letters, such as Aaa, Baa, Caa, Aa, Ba, Ca, A, etc…


favorites exclusive rights to manufacture or trade in some commodity.”

For instance, the two housing GSEs have a $2.25 billion line of credit with the United States Treasury Department, which suggests that there is available government financial support if necessary. The President of the United States is authorized to appoint up to five of the eighteen members of the two housing GSEs’ respective boards of directors. Up until July of 2002, they were also exempt from having to “register their securities and file annual and periodic reports with the SEC” under the Securities Exchange Act of 1934, which is a requirement imposed on all other publicly traded companies. Even after agreeing to register their securities under the Securities and Exchange Act of 1934, the agreement only applied to their equity securities, not their debt and mortgage-backed securities that they routinely issue.

Finally, and perhaps most importantly, Fannie Mae and Freddie Mac’s special relationship with the federal government permits them to be the recipients of an indirect privilege: namely, that federally insured banks and thrifts are allowed, by law, to invest in GSE debt securities in unlimited quantities. Excluding the two housing GSEs, “regulated financial institutions can invest no more than 10 percent of their capital in the debt issued by a single bank.”

One could interpret this legal privilege as a “wink” from the federal government to investors that the debt of Fannie Mae and Freddie Mac is safer than the debt issued by other financial institutions.

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2631 Ibid., “The Fannie/Freddie Time Bomb.”
The confluence of factors listed above created a common perception that Fannie Mae and Freddie Mac’s debt obligations were tacitly guaranteed by the federal government. As Thomas Stanton aptly states, whereas United States Treasury bonds are a “general obligation” of the federal government, the obligations of Fannie Mae and Freddie Mac are “what might be called a moral obligation” of the federal government.\(^{2633}\) As early as 1989, Marcia Stigum, in her book *The Money Market*, argued that the “[government]-sponsored agencies such as Fannie Mae… are regarded by most people that lend to them as the government in disguise.”\(^{2634}\) In May of 1996, the Congressional Budget Office published a report titled “Assessing the Public Costs and Benefits of Fannie Mae and Freddie Mac.” The Congressional Budget Office frankly acknowledged the existence of the implied federal government guarantee in this report, contending that “[s]hort of placing an explicit guarantee on the securities of the housing GSEs, the law could hardly be more clear: the government’s financial interests in the safety of Fannie Mae and Freddie Mac ensure that their obligations are safe from the risk of default.”\(^{2635}\) With respect to this study, what is important about this implied guarantee is that it enabled Fannie Mae and Freddie Mac to be the recipients of a unique subsidy that possessed an “opaque” transmission structure.\(^{2636}\) It is necessary, therefore, to examine the form and content of this implicit government subsidy. An analogy may be helpful here.

\(^{2633}\) *Government-Sponsored Enterprises: Mercantilist Companies in the Modern World*, 37.


When a college student receives a federal subsidized loan from a financial institution, the subsidy comes in the form of the federal government directly paying the accrued interest on the loan during the period of time in which it is in deferral status. The amount of the subsidy is transparent in the sense that it would be both for a certain specified dollar amount and part of the federal budget that was allocated for subsidizing higher education. One would be able to discover how much the subsidy was for and the kind of subsidy that it was.

The subsidy that the two housing GSEs have received, however, differs from the student loan subsidy because the government did not deliver it “in the form of Treasury checks made out to Fannie Mae and Freddie Mac.”\textsuperscript{2637} June O’Neill, in 1996, noted that the entire federal budget, along with “all 1,174 pages” of President Clinton’s proposed budget, did not have “a single dollar… [that was] slated to be paid as a subsidy to the housing GSEs.”\textsuperscript{2638} How can one maintain, then, that Fannie Mae and Freddie Mac received a federal subsidy, if there was no actual outlay of funds from the federal government to the GSEs? Can there be such a thing as a non-cash subsidy?

One way to begin answering this question is to note that a person or institution’s financial position can be improved by being exempt from having to pay certain taxes or fees. Exemptions of this sort free up one’s capital for other purposes. In 2004, the Congressional Budget Office (CBO) estimated that Fannie Mae received tax and regulatory exemptions worth $600 million in 2000, $800 million in 2001, $600 million in

\textsuperscript{2638} Ibid.
2002, and $1 billion in 2003.\textsuperscript{2639} As for Freddie Mac, the same report estimated that it received tax and regulatory exemptions worth $400 million in 2000, $500 million in 2001, and $1.3 billion in 2002.\textsuperscript{2640} The purported congressional reason for these exemptions is that they help the two housing GSEs provide low-cost financing for homebuyers across America.\textsuperscript{2641}

Fannie Mae and Freddie Mac also received an additional, more valuable subsidy that is more difficult to discern: they received free credit enhancement due to the aforementioned implied federal government guarantee of their debt obligations.\textsuperscript{2642} In a helpful analogy, W. Scott Frame and Larry Wall liken the implicit federal government guarantee to parents agreeing to co-sign a loan for one or more of their college-bound children. By co-signing a loan, the parents are providing a valuable benefit to their child. The benefit comes in the form of the child receiving more favorable loan terms than those that he or she could receive absent of the parental co-signing. The parents not only make this benefit possible, they also provide the benefit without actually making any monetary payment, assuming that the child repays the amount that he or she borrowed in a timely fashion.\textsuperscript{2643} Similarly, the fact that the investing public and even the credit rating agencies believe that the federal government is standing behind the two housing GSEs’ debt

\textsuperscript{2640} Ibid. Data on Freddie Mac for 2003 was incomplete.
obligations, Fannie Mae and Freddie Mac were able to lower their borrowing costs.\footnote{Evidence supporting the claim that investors and the credit rating agencies anticipated that the federal government was tacitly standing behind Fannie Mae and Freddie Mac’s debt obligations can be found in an April 14, 2008 report published by Standard and Poor’s. In this report, Standard and Poor’s claimed that Fannie Mae and Freddie Mac were the single biggest threats to the United States government’s AAA rating. Please see Prabha Natarajan, “GSEs Could Affect U.S. Credit Rating,” \textit{The Wall Street Journal} (April 15, 2008).} Lawrence White notes that, absent the implied guarantee, “the financial markets would either insist on a stronger balance sheet [from Fannie Mae and Freddie Mac] with more capital (net worth) as protection (which would be costly for the two companies) so as to achieve the AAA rating commensurate with the current interest rates at which they borrow; or the financial markets would insist on charging higher interest rates (which would be costly) commensurate with their current balance sheets.”\footnote{Lawrence J. White, “Fannie Mae, Freddie Mac, and Housing Finance: Why True Privatization is Good Public Policy,” (October 7, 2004), \textit{available at} http://www.cato.org/pubs/pas/html/pa528/pa528index.html, 35.} In 2004, White estimated that the federal government’s “annualized contingent liability” stemming from the implied guarantee of the two housing GSEs’ debt obligations came to $12-13 billion.\footnote{Ibid., 36.}

Part of the significance of the implicit federal government guarantee can be grasped by way of the following consideration. In general, the perceived risk associated with an investment shapes the potential return on that investment. If investment opportunity $x$ is perceived to be riskier than investment opportunity $y$, $x$ will likely have a potential higher rate of return than $y$ to compensate for the greater risk. Since investors tended to view the federal government as “co-signers” on the loans that they were making to Fannie Mae and Freddie Mac, they were willing to accept artificially low rates of return on their investment, irrespective of the two housing GSEs’ true default risk, the
risk associated with their ability to repay those loans with interest in a timely fashion. To phrase this point differently, Fannie Mae and Freddie Mac were able to borrow money more cheaply than they otherwise could have done because investors viewed their debt securities as being implicitly guaranteed by the federal government and, hence, as safer investments than they would be standing alone, devoid of the implicit guarantee.

As far back as 1990, the United States General Accounting Office (GAO) expressed concern over Fannie Mae and Freddie Mac’s privileged borrowing position. In a report titled “Government-Sponsored Enterprises: The Government’s Exposure to Risks,” the General Accounting Office noted that the two housing GSEs’ ties with the federal government were weakening “the discipline that creditors normally provide to completely private firms.” The creditor or investor perception of the implicit federal guarantee of the two housing GSEs’ debt obligations made it possible for Fannie Mae and Freddie Mac to borrow money from them at lower interest rates. Douglas Holtz-Eakin argues that the two housing GSEs’ “ability to borrow at lower rates of interest than any fully private firm holding the same amount of private equity capital and taking the same risks” is “the principal benefit” of having the GSE status. A 1996 Congressional Budget Office report laments the federal government’s provision of free credit enhancement to Fannie Mae and Freddie Mac because it is costly to taxpayers. Rather than offering the credit enhancement for free, the report incisively notes, “the government

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2649 Douglas Holtz-Eakin, “Testimony Before the United States Senate Committee on Banking, Housing, and Urban Affairs.”
could sell the right to share its credit standing... [and from] the receipts of such a sale, the government could increase spending for any public purpose or reduce taxes.”

In 2004, the Congressional Budget Office estimated that between 1995 and 1999, Fannie Mae and Freddie Mac received a total of $13.9 billion in off-budget federal subsidies. In the same report, the CBO estimated that the two housing GSEs received $22.9 billion in off-budget federal subsidies from 2000-2003. Wayne Passmore, a Federal Reserve economist, reported in a 2005 study that Fannie Mae and Freddie Mac received a median gross subsidy worth $149 billion between April 1997 and May 2003. Provocatively, Passmore also estimated that 44% to 89% of the two housing GSEs’ respective market values are due to the implicit federal government subsidy. The Congressional Budget Office, in an earlier 1996 report, found that 42% of Fannie Mae and Freddie Mac’s profits in 1995 were either directly or indirectly derived from their government backing.

Nevertheless, Fannie Mae has publicly called the subsidy “theoretical” because they have never received a check from the federal government. Former Chairman and CEO of Fannie Mae, Franklin Raines, has denied altogether that the housing GSE receives a subsidy, and no less than former Treasury Secretary Paul O’Neill has

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2650 “Assessing the Public Costs and Benefits of Fannie Mae and Freddie Mac,” 11.
2653 Ibid., 14.
2654 “Assessing the Public Costs and Benefits of Fannie Mae and Freddie Mac,” 22.
publicly agreed with him. Former Executive Vice President of Fannie Mae, Robert Zoellick, also voiced a clear denial of receiving a federal subsidy. In his July 31, 1996 testimony before the House of Representatives Subcommittee on Capital Markets, Securities and Government-Sponsored Enterprises, Zoellick asserted that Fannie Mae does “not receive any federal subsidies… [and their] debt is not guaranteed by the federal government.” Zoellick also testified that it “is impossible to accurately measure the value of a subsidy that does not explicitly exist,” yet it is possible to “identify the many tangible benefits” that Fannie Mae provides to homebuyers.

6.5. What do Fannie Mae and Freddie Mac do?

Fannie Mae and Freddie Mac engage in two lines of business, neither of which involves making mortgage loans directly to home-buyers. As Alan Greenspan explains:

The first is… [that Fannie Mae and Freddie Mac] purchase mortgages, bundle them together, and then sell claims on the cash flows to be generated by these bundles. These claims are known as mortgage-backed securities. The second… involves Fannie’s and Freddie’s purchasing mortgages or their own mortgage-backed securities outright and financing those purchases by selling debt [to investors] directly in the name of the GSE.

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2659 Ibid.
2660 Underwriting mortgages, or the process of discerning the level of risk that a given borrower possesses, used to be the responsibility of the parties in the primary mortgage market. Fannie Mae and Freddie Mac became the largest underwriters of mortgages after they developed their own automated underwriting systems. Fannie Mae’s system is called “Desktop Underwriter,” while Freddie Mac’s is called “Loan Prospector.”

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In the first line of business, “they issue and guarantee mortgage-backed securities,” while in the second line of business they “invest in mortgage assets” and hold them in their respective portfolios.  

In 1980, Fannie Mae and Freddie Mac’s share of residential mortgage debt outstanding through these two lines of business was around 7%. By the end of June 2008, this share grew to nearly 50%. Both of these lines of business warrant closer inspection, as they are the primary activities by which the two housing GSEs attempt to meet the demands of their charters and generate profits for their shareholders.

What is involved in issuing and guaranteeing mortgage-backed securities and, furthermore, how do these activities contribute to making mortgage investments more liquid and the secondary market more stable? In an effort to answer these questions, it will be useful to examine the process of mortgage securitization, for it is an indispensable element of this first line of business. A 1996 United States Treasury Department report describes the process of mortgage securitization as one involving the transformation of “illiquid mortgage loans into liquid, tradable mortgage-backed securities, which represent interests in a pool of loans.” Prior to 1970, “mortgages were largely a non-traded debt instrument.” Those lenders that originated mortgage loans typically held on to them until they matured or were prepaid, “collecting interest and principal repayments in the interim.” The Government National Mortgage Association (Ginnie Mae) began

2662 Lawrence J. White, “Fannie Mae, Freddie Mac, and Housing Finance: Why True Privatization is Good Public Policy,” 2.
2664 Ibid.
2667 Ibid.
issuing the first “pass-through” mortgage-backed securities in 1970. Freddie Mac and Fannie began issuing pass-through mortgage-backed securities of their own in 1971 and 1981, respectively.2668 How are illiquid mortgage loans transformed into liquid, tradable, pass-through mortgage-backed securities?

Fannie Mae and Freddie Mac are permitted to buy both individual and groups of mortgages from the financial institutions (the lenders) that originated them on the primary market, provided that the loan or loans meet their requirements. The two housing GSEs are required by law to purchase “single-family mortgages with origination balances below a specified amount, known as ‘the conforming loan limit.’”2669 From 1980 through 2010, the conforming loan limit increased 344.8%, from $93,750 to $417,000. Between 1996 and 2002, the conforming loan limit grew 45.3%. From 2002 to 2010, the conforming loan limit increased another 38.7%. Beginning in 2008, what constitutes the conforming loan limit is contingent upon the area in which the property unit is located. As determined by the Federal Housing Finance Agency, the “general” single unit conforming loan limit as of 20102670 is $417,000, while the “high-cost” single unit conforming loan limit is $729,750.2671 A residential mortgage financing a single unit property in Allegany County, Maryland, has a “general” conforming loan limit of $417,000, while a residential mortgage financing a single unit property in Dukes County,

2670 Excluding Hawaii and Alaska, but including Washington D.C. and Puerto Rico.
Massachusetts has a “high-cost” conforming loan limit of $729,750.\textsuperscript{2672} Both of the housing GSEs would be prohibited from buying a mortgage financing a single unit residential property in either of those areas, should the amount of the mortgage exceed the designated conforming loan limit.

In a typical transaction between the housing GSEs and a lender on the primary market, the former will buy a pool of mortgages from the latter. The mortgages within this pool, in addition to meeting all of Fannie Mae and Freddie Mac’s requirements, will usually have “similar interest rate structures, age, and underwriting characteristics.”\textsuperscript{2673} Next, by way of a swap-transaction, the ownership-interest in the pool of loans is converted into a security, a bond, known as a mortgage-backed security, which can then be sold on the secondary market.\textsuperscript{2674} Each mortgage-backed security has a coupon, which is the interest rate that an investor receives, shorn of a servicing fee and a guarantee fee, should he or she choose to invest in the security.\textsuperscript{2675} The servicing fee goes to the institution that is responsible for collecting the payments made by the borrowers of the mortgage loans and the two housing GSEs retain the guarantee fee. The reason that the mortgage-backed security is labeled a “pass-through” is due to the fact that the interest received by Fannie Mae and Freddie Mac on the underlying loans, minus the servicing and guarantee fees, is passed through to those that invested in the security.\textsuperscript{2676}

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\item \textsuperscript{2673} Government Sponsorship of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation, 22.
\item \textsuperscript{2674} Lawrence J. White, “Mortgage-Backed Securities: Another Way to Finance Housing,” 6.
\item \textsuperscript{2676} Ibid., 26.
\end{itemize}
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It is by way of the guarantee fee, usually around 20 basis points or one-fifth of one-percent of the remaining principal, that Fannie Mae and Freddie Mac make money in this line of business.\textsuperscript{2677} The guarantee that they provide for the fee is that there will be timely repayment of principal and interest to the investor, even if it has not been collected from the borrower.\textsuperscript{2678} If the mortgage loans backing the security are amortizing fixed-rate mortgages, then each is scheduled to pay interest and principal each month, which Fannie Mae and Freddie Mac would be responsible for passing along to investors, minus the fees listed above, regardless of whether all of the borrowers made their monthly mortgage payments on time.\textsuperscript{2679} Mortgage-backed securities containing variable rate mortgages have the interest passed through on the basis of a weighted average pass through rate, one that varies depending upon any adjustments in the interest rates of the mortgages as well as prepayments made by borrowers.\textsuperscript{2680}

One other point about the two housing GSEs’ form of securitization is worth mentioning. From the perspective of the borrower, securitization has the benefit of making residential mortgage financing more available. The enhanced availability of mortgage financing, however, comes at the expense of exacerbating the problem of asymmetric information that accompanies loan transactions of all kinds. As Lawrence White explains, when “Party A lends money or resources to Party B at time $t$ and expects to be repaid at some future time $t+1$,” Party A “must generally be concerned about the

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  \item[2679] Ibid.
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assurance of repayment."\textsuperscript{2681} Mortgage lenders face the problem of asymmetric information because the borrower is much more likely to “know more about its own proclivities with respect to repayment than does the lender.”\textsuperscript{2682} Therefore, a lender will usually attempt to assess the creditworthiness of a borrower by gathering extensive before-the-loan information on and making during-the-loan observations of that borrower.\textsuperscript{2683} Securitization creates a situation in which investors in Fannie Mae and Freddie Mac-issued mortgage-backed securities are even further removed from being able to assess the creditworthiness of the borrowers whose mortgages are backing their investments.

Fannie Mae and Freddie Mac’s guarantee enables them to create investment opportunities that are devoid of credit risk, which, in this case, is the risk that borrowers will not meet their mortgage obligations. Their guarantee, however, does not protect investors from prepayment risk, which is the risk that all or part of the principal of a pool of mortgage loans will be paid back prior to the loans’ final scheduled payment dates. In a given mortgage-backed security, should any of the borrowers whose mortgages are in the security refinance their mortgages at lower interest rates, relocate and sell their homes, or default on their mortgages, at least some of the principal will be returned to those who invested in that security ahead of the amortization schedule.\textsuperscript{2684} The prepayment risk of investing in a Fannie Mae or Freddie Mac-issued mortgage-backed security in this case is not whether one will receive one’s investment back, but rather that one will fail to receive the \textit{expected return} on that investment. The effects of prepayment

\textsuperscript{2681} Lawrence J. White, “Mortgage-Backed Securities: Another Way to Finance Housing,” 3.
\textsuperscript{2682} Ibid.
\textsuperscript{2683} Ibid.
risk can be acutely felt when, upon receiving one’s guaranteed principal earlier than expected, interest rates have dropped since the time of original investment of that principal. In essence, an investor in a Fannie Mae or Freddie Mac-issued mortgage-backed security is “buying a future stream of payments that will result in a particular yield over a particular time period.” If one invests $10,000 into a mortgage-backed security in 1991 with a coupon of 9% and a maturity of ten years, one would anticipate earning a return of 9% on that investment for ten years. However, for illustrative purposes, suppose that for one reason or another all of the mortgages in that mortgage-backed security are paid off in full in 1996. Suppose further that interest rates have dropped to 6%. In this scenario, one would be deprived of the future interest payments on the invested principal at the expected 9% rate and, additionally, one would likely be unable “to earn the same yield elsewhere.”

A June 1, 2009 Fannie Mae single family mortgage-backed security prospectus identifies other investor risks including the potential for prevailing interest rates to rise, which would cause borrowers to prepay less rapidly, thereby resulting in both slower borrower loan payments and, ultimately, the investor having his or her capital tied up “at a time when reinvestment rates are higher.” In sum, the Fannie Mae and Freddie Mac guarantee only ensures that investors in their mortgage-backed securities will receive interest payments insofar as there is still principal invested to earn interest, that they will receive the interest in a timely fashion, and that they will not lose their principal. The two

\[\text{2685} \quad \text{Guy Stuart, } \textit{Discriminating Risk: The U.S. Mortgage Lending Industry in the Twentieth Century} \text{ (Ithaca: Cornell University, 2003), 99.}\]
\[\text{2686} \quad \text{Ibid.}\]
\[\text{2687} \quad \text{Fannie Mae, “Guaranteed Mortgage Pass-Through Certificates: Single-Family Residential Mortgage Loans,” 26.}\]
housing GSEs are not guaranteeing that investors will actually make any money on their investments.

Historically, the credit risk associated with this securitization-and-guarantee line of business has been low for Fannie Mae and Freddie Mac. Peter Wallison estimates that, in the early 2000’s, credit risk related losses totaled around one to two basis points, while Lawrence White maintains that between 1987 and 2002, credit risk related losses averaged approximately 5.4 basis points annually. Given that this line of business was relatively safe and assuming that it adequately provided stability and liquidity in the secondary mortgage market, why did the two housing GSEs also continue to partake in a second line of business, Fannie Mae’s original line of business of purchasing and holding mortgages and mortgage-backed securities? Wallison insightfully notes that engaging in this second line of business, after the advent of securitization, is “highly counterintuitive.” After all, he adds, “the essence of liquidity is supply – a large number of [mortgage-backed] securities available for purchase or sale,” but the purchasing-and-holding line of business reduces the supply of mortgage-backed securities available to the market, and consequently reduces liquidity. For every mortgage-backed security that the two housing GSEs hold in their portfolios, that is one less mortgage-backed security available to attract investor capital.

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2691 Ibid.
2692 In his June 15, 2006 testimony before the Senate Committee on Banking, Housing, and Urban Affairs, the CEO of Fannie Mae, Daniel Mudd, stated that roughly 50% of Fannie Mae’s retained portfolio consisted of “conventional, conforming mortgage-backed securities.” As for the remaining portion of the
Former Chairman and CEO of Freddie Mac, Richard Syron, provides one justification for participating in this second line of business. The reason that the two housing GSEs purchase and hold mortgage-backed securities in their retained portfolios is that it is, in fact, a “critical” part of their effort to meet the requirements of their chartered mission to ensure “liquidity, stability, and affordability of mortgage credit across the country.” The fact that “the demand for mortgage assets is volatile and unpredictable,” could potentially serve as a formidable obstacle that would prevent them from making the secondary mortgage market more stable and liquid. At any given time, it is difficult to accurately forecast how much investor demand there will be for their issued mortgage-backed securities. Syron maintains that their retained portfolios serve as “an important corollary to the securitization process” because investors know that Fannie Mae and Freddie Mac will buy their mortgage-backed securities if they later need to sell. Thus, the retained portfolio line of business reassures investors, which, in turn, “supports demand” for their issued mortgage-backed securities by creating a larger domestic and international investor base for those securities. Ultimately, then, this line of business “helps keep the markets liquid and mortgage rates low across economic environments.” Syron estimates that about two-thirds of Freddie Mac’s retained portfolio, Mudd stated that 35% consists of “whole loans that are not packaged into mortgage-backed securities” and 14% consists of “municipal securities, subprime securities, Alt-A securities, and revenue bonds.” United States Senate Committee on Banking, Housing, and Urban Affairs, “The OFHEO Report of the Special Examination of Fannie Mae,” (June 15, 2006), available at http://www.access.gpo.gov/congress/senate/senate05sh109.html, 57-58. Richard Syron, “Testimony Before the United States House of Representatives Committee on Financial Services,” (March 15, 2007), available at http://www.freddiemac.com/corporate/company_profile/pdf/syron3-15-07finaltestimonypdf.pdf

Ibid.


Ibid., “Testimony Before the United States House of Representatives Committee on Financial Services.”
mortgage portfolio “either directly or indirectly supports the affordable housing component” of their mission.2697

Indeed, when Democrats in the United States Senate Committee on Banking, Housing, and Urban Affairs voted against a 2005 bill, S. 190, that aimed to severely restrict the two housing GSEs’ retained portfolios, the reason for their dissent closely mirrored Syron’s justification. The Democratic Senators stated, “The retained portfolios of Fannie Mae and Freddie Mac help keep interest rates low; they have helped markets function effectively, even when other sectors experienced severe credit crunch problems; and they attract funds from all over the world to be invested in the U.S. mortgage markets.”2698 There is a considerable body of research available that supports this argument.2699

It would be a mistake, however, to conclude that this argument has been universally accepted. For instance, on February 24, 2004, the Federal Reserve Chairman at the time, Alan Greenspan, testified before the United States Senate Committee on Banking, Housing, and Urban Affairs and he asserted that “[d]eep and liquid markets for mortgages are made using mortgage-backed securities that are held by non-GSE investors” as opposed to being held by the two housing GSEs themselves.2700 Greenspan

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2697 Ibid.
2700 Alan Greenspan, “Testimony Before the United States Senate Committee on Banking, Housing, and Urban Affairs.”
further stated that “Fannie’s and Freddie’s purchases of their own or each other’s securities with their debt do not appear [to be] needed to supply mortgage market liquidity or to enhance capital markets in the United States.”

Likewise, Douglas Holtz-Eakin, former director of the Congressional Budget Office, categorically affirms that the “large mortgage portfolios held by Fannie Mae and Freddie Mac are not necessary for the secondary mortgage market to operate efficiently; those enterprises issuance of mortgage-backed securities can accomplish that outcome.”

In terms of Fannie Mae and Freddie Mac’s retained portfolios contributing to the goal of lowering mortgage rates, a study conducted by three Federal Reserve economists found that the effects of the retained portfolios on “both secondary and primary mortgage rate spreads” were not “statistically different from zero,” accounting for a difference in mortgage interest rates of approximately two basis points, or one-fiftieth of one-percent. In a July 12, 2006 editorial in the congressional newspaper, The Hill, Senator Richard Shelby bluntly declared that that the two housing GSEs’ retained portfolios “have only been used as a vehicle for corruption, mismanagement and greed,” which GSE reform must eliminate.

Precisely how the two housing GSEs’ retained portfolios benefit the secondary mortgage market and borrowers is, in my opinion, unclear and, moreover, whether any benefits are conferred at all is questionable. A far less controversial justification for the

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2701 Ibid.
2704 Peter J. Wallison, “Facing Facts on Fannie and Freddie.”
retained portfolio line of business is that it is extremely profitable. Whereas the average guarantee fee (from the first line of business) was a little over 20 basis points in 2003, the average spread between “the interest rate earned on the mortgage assets [in a housing GSE’s retained portfolio] and the interest cost of the funding liabilities” was 172 basis points for Fannie Mae and 186 basis points for Freddie Mac that same year.\(^{2706}\) As Dwight Jaffee makes clear, the “relatively large size of this rate spread arises from the low interest cost of the F&F debt (due to the implicit Treasury guarantee) and the compensation for accepting the interest rate risk associated with the mortgage securities held in the portfolios.”\(^{2707}\) Investors are willing to accept lower returns from the two housing GSEs – even lower than the returns provided by AAA-rated bonds - because, as it was argued before, the implied federal government guarantee creates the impression that, one way or another, Fannie Mae and Freddie Mac will meet their debt obligations. The profound competitive advantage that emerges is that Fannie Mae and Freddie Mac can purchase and hold their own or one another’s mortgage-backed securities with the capital raised by selling bonds to investors with yields that are lower than those returns expected from the mortgage-backed securities. If the two housing GSEs can “borrow funds at 4% to buy mortgages that pay 5%, they will do quite well.”\(^{2708}\)

In terms of revenue, Fannie Mae and Freddie Mac generated over $22 billion from the net interest received on their retained portfolios in 2003, compared to about $4 billion from guarantee fees on their mortgage-backed securities that same year.\(^{2709}\)


\(^{2707}\) Ibid.


1997 to 2001, Fannie Mae had an average return on equity generated by their retained portfolio line of business of 29.22%, while Freddie Mac averaged a return on equity of 24.54% from the same line of business.\textsuperscript{2710} Comparatively, the industry return on equity “for all FDIC insured commercial banks” from 1998-2002 was around 13.6%.\textsuperscript{2711}

With respect to the size of their retained portfolios, Gloria Gonzalez-Rivera estimates that, at the end of 1999, Fannie Mae’s portfolio was worth about $523 billion, while Freddie Mac’s was worth approximately $324 billion.\textsuperscript{2712} By the end of 2001, “the GSEs together held in their portfolios about one-third of all mortgage-backed securities outstanding, [worth] about $1.2 trillion.”\textsuperscript{2713} Four years later, at the end of 2005, their retained portfolios had an aggregate value of approximately $1.5 trillion.\textsuperscript{2714} As of June 30, 2008, this figure ballooned to $1.8 trillion.\textsuperscript{2715} In contrast to their first line of business, the two housing GSEs’ retained portfolio line of business is both more profitable and has grown more rapidly. Although it is debatable whether their retained portfolios are necessary for fulfilling the demands imposed by their federal charters, the profits generated by those portfolios provide a compelling incentive for Fannie Mae and Freddie Mac to engage in that line of business.

At this point, one may be tempted to believe that the question of whether Fannie Mae and Freddie Mac should engage in the retained portfolio line of business is one that

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\textsuperscript{2711} W. Scott Frame and Lawrence J. White, “Fussing and Fuming over Fannie and Freddie: How Much Smoke, How Much Fire?,” 178.


\textsuperscript{2713} Peter J. Wallison, “The Fannie/Freddie Time Bomb.”


\textsuperscript{2715} “The 2008 Federal Intervention to Stabilize Fannie Mae and Freddie Mac,” 8.
\end{footnotesize}
is of minimal importance. Maybe this line of business assists the two housing GSEs with meeting the requirements of their federal charters, or perhaps it does not. In either case, one could reason, this line of business is, by the most unfavorable appraisal, a mere opportunistic pursuit of profit. Even if their retained portfolios are not directly assisting their federally mandated efforts to create a stable and liquid secondary mortgage market, these portfolios are not \textit{detracting} from those efforts and should, subsequently, be permitted.

Such a conclusion, however, overlooks the fact that the two housing GSEs’ retained portfolios were at the heart of political concerns over the extent to which Fannie Mae and Freddie Mac should be regulated in the early 2000’s. At first glance, this is a surprising claim. As mentioned before, Fannie Mae’s original line of business, dating back to 1938, was its retained portfolio line of business. Furthermore, from at least 1990 for Fannie Mae and 1980 for Freddie Mac, the total amount of their respective outstanding issued mortgage-backed securities, excluding the mortgage-backed securities that were held in their portfolios, exceeded the total amount of their retained portfolios.\footnote{W. Scott Frame and Lawrence J. White, “Fussing and Fuming over Fannie and Freddie: How Much Smoke, How Much Fire?,” 172.} So whatever the concern over the retained portfolios happened to be, the securitization-and-guarantee line of business is larger. One may wonder, then, why their securitization-and-guarantee line of business was not the focal point of regulation discussions in the early 2000’s. Why was there concern over regulating Fannie Mae and Freddie Mac in the first place? I will address each of these questions in turn.
6.6. Why the Retained Portfolio Line of Business is Riskier Than the Securitization-and-Guarantee Line of Business

Before examining Congress’ efforts to regulate Fannie Mae and Freddie Mac in the early 2000’s, it would be helpful to explain why their respective retained portfolio lines of business were a congressional cause for concern during this time. Briefly stated, although Fannie Mae and Freddie Mac’s securitization-and-guarantee line of business was bigger, their retained portfolio line of business was, and continues to be, far riskier. As mentioned before, in their securitization-and-guarantee line of business, one who invests in a Fannie Mae or Freddie Mac mortgage-backed security assumes all of the risks accompanying that investment, except for the credit risk, which is borne by either of the housing GSEs. Conversely, in their retained portfolio line of business, it is Fannie Mae and Freddie Mac themselves who assume all of the risks associated with investing in their own mortgage-backed securities, with interest-rate risk being the most dangerous one.

Interest-rate risk exists because market interest rates change and are extremely difficult, if not impossible, to predict. It is important to note that, regardless of whether interest rates rise or fall, Fannie Mae and Freddie Mac’s retained portfolio line of business can be harmed. To return to a previous example, if either of the housing GSEs borrow money from investors at, say, 4%, and purchase and hold mortgages that pay an average of 5%, they will make a handsome profit.2717 However, if the interest rates on the funds that they borrowed from investors eventually rises to 6%, the two housing GSEs will lose money as long as they are paying investors “above the average rate [that] they

2717 Peter J. Wallison, “Fannie and Freddie’s Gambit.”
receive on the mortgages in their portfolios.\textsuperscript{2718} In other words, the cost of borrowing money can unexpectedly rise, which can, in turn, transform once-profitable mortgage payment streams into investment losses.

Another troubling aspect of interest-rate risk is that Fannie Mae and Freddie Mac can also experience losses if interest rates fall. Homeowners tend to refinance their mortgages when interest rates go down. If either of the housing GSEs are holding mortgages that happen to be refinanced in their portfolios, those mortgage loans are, from Fannie Mae and Freddie Mac’s perspective, repaid in full. Although they could opt to buy and hold replacement mortgages, those mortgages would probably have interest rates at the prevailing, lower rate, meaning that borrowers would be paying less in interest charges. The situation can become especially grave for Fannie Mae and Freddie Mac if an influx of mortgages in their mortgage-backed securities are paid off (refinanced) before the bonds that helped finance the purchase of those securities mature. The challenge is that, in such a situation, Fannie Mae or Freddie Mac would have previously “locked” themselves into an interest rate that they are obligated to pay their bond investors, but the projected source of funding the interest due on those bonds (mortgage payments made by borrowers over the course of a predetermined time) has now disappeared.

Exactly how Fannie Mae and Freddie Mac attempt to grapple with mismatches between the life of mortgages in their mortgage-backed securities and the life of the bonds that fund the purchase of those mortgage-backed securities – let alone how the two housing GSEs accommodate rising and falling market interest rates - is a question that cannot be explored in this study. The key point is that the form of interest-rate risk that

\textsuperscript{2718} Ibid.
has just been described is one of the primary reasons that Fannie Mae and Freddie Mac’s retained portfolio line of business is much riskier than their securitization-and-guarantee line of business. In the latter line of business, investors assume the interest-rate risk, while the housing GSEs simply take on the credit risk. In the retained portfolio line of business, Fannie Mae and Freddie Mac are exposed to both types of risk.\textsuperscript{2719}

It would be amiss not to mention that, time and again, Fannie Mae and Freddie Mac in the early 2000’s denied that their retained portfolios were risky and resisted any congressionally enforced limitations on their portfolios. The two-pronged argument that the two housing GSEs put forth to delegitimize claims that their retained portfolios were risky was: (1) their retained portfolios are mostly homogenous, consisting almost entirely of residential mortgages, which makes the retained portfolios easier to manage; and (2) residential mortgages are among the safest investments available. Combining the two parts of the argument, one can arrive at the conclusion that the housing GSEs’ retained portfolios carry with them very little risk, since residential mortgages are safe assets to own and the retained portfolios themselves contain mostly the same type of product, residential mortgages.\textsuperscript{2720}

R. Glenn Hubbard, Dean of the Columbia University Graduate School of Business, argued in a 2004 Fannie Mae-commissioned paper that the homogeneity of the housing GSE’s mortgage-based balance sheet was a boon, since losses on mortgages

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\textsuperscript{2719} Jerry Knight, “Loan Refinancings Put the Squeeze on Fannie Mae,” The Washington Post (September 23, 2002).
\textsuperscript{2720} Daniel Mudd, the former CEO of Fannie Mae, presented this argument practically word for word in his written response to a question asked by Senator Mel Martinez. Mudd’s response was part of his testimony before the Senate Committee on Banking, Housing, and Urban Affairs on June 15, 2006. Mudd affirmed, “Fannie Mae invests exclusively in residential mortgages – among the safest assets in the world – which allows us to focus on managing their risks, making it less complex for us than managing the range of assets that others do.” United States Senate Committee on Banking, Housing, and Urban Affairs, “The OFHEO Report of the Special Examination of Fannie Mae,” 138.
\end{footnotesize}
have been historically low.\textsuperscript{2721} Hubbard also maintained that Fannie Mae’s risk on a “stand-alone” basis was low in absolute as well as relative terms. In absolute terms, the probability of Fannie Mae defaulting on their obligations, according to Hubbard, stood at around one in 1,000. Relative to other large commercial banks, Hubbard stated that the likelihood of a Fannie Mae default was lower, with a lower expected loss should a default actually take place.\textsuperscript{2722} In a later section, I will touch upon another purported reason why Fannie Mae and Freddie Mac resisted limitations on their retained portfolios: because such limitations would have inhibited their ability to fulfill the demands of their chartered mission.

6.7. The Deterioration of Fannie Mae and Freddie Mac’s Reputations: The Early 2000’s

From 1995 to 2003, Fannie Mae and Freddie Mac were highly profitable companies. In each of those years, Fannie Mae was ranked in the Top 30 of Fortune magazine’s “Most Profitable Companies” list, while Freddie Mac consistently ranked in the Top 65. Whereas Fannie Mae posted $2.131 billion in profits in 1995, they posted $4.618 billion in profits in 2003. Freddie Mac, on the other hand, posted $983 million in profits in 1995 and, eight years later in 2003, posted an extraordinary $5.764 billion in


profits.\textsuperscript{2723} In total, Fannie Mae made over $32.5 billion during those eight years and Freddie Mac made over $21 billion.\textsuperscript{2724} One can also get an idea of the two housing GSEs’ phenomenal growth by considering that, from 1984-1998, Fannie Mae’s stock rose 14,000\%, outperforming 99.8\% of all United States equity investments. Freddie Mac’s stock, from 1989-1998, actually outperformed that of Fannie Mae!\textsuperscript{2725}

Accompanying their profitability, during the late 1990’s and early 2000’s the two housing GSEs enjoyed, for the most part, a very positive public image. A November 4, 2001 article in \textit{The New York Times} featured the headline, “Learning to Love Fannie and Freddie,” and applied American actress Mae West’s famous quote that “too much of a good thing can be wonderful” to the way that Wall Street security analysts felt about Fannie Mae.\textsuperscript{2726} The housing GSE was one of eleven companies profiled in the 2001 best selling business book \textit{Good to Great: Why Some Companies Make the Leap... and Others Don’t}, written by Jim Collins. At one point in the book, Collins expresses his astonishment over Fannie Mae’s profit performance and asks, “Who would have thought that Fannie Mae would beat companies like GE and Coca-Cola?”\textsuperscript{2727} The two housing GSEs were also the top charitable contributors in Washington D.C. in 2001, according to

\textsuperscript{2723} This information was found at CNN\textsc{money} magazine’s “Fortune 500 Database,” \textit{available at} http://money.cnn.com/magazines/fortune/fortune500\_archive/full/1955.

\textsuperscript{2724} Ibid.


the \textit{Washington Business Journal}, with Fannie Mae and Freddie Mac making contributions of $27.1 million and $13.8 million, respectively.\textsuperscript{2728}

Fannie Mae was recognized as one of “America’s Most Admired Companies” by \textit{Fortune} magazine and, in the spring of 2004, \textit{Business Ethics} magazine ranked it #1 in its list of the “100 Best Corporate Citizens.” The criteria used to inform this ranking included the company’s service to stockholders, employees, customers, and the community. This ranking was not an anomaly. \textit{Business Ethics} magazine ranked Fannie Mae #9 in 2000, #3 in 2001, #3 in 2002, and #12 in 2003.\textsuperscript{2729} In January of 2003, Standard and Poor’s gave Fannie Mae a corporate governance score of a 9 out of 10, noting that the housing GSE was “not only demonstrating its own strong governance practices,” but it was also “showing leadership in the United States with regard to providing greater openness and disclosure about its corporate governance standards.”\textsuperscript{2730}

As for Freddie Mac, it appeared on Fortune magazine’s list of “America’s Most Admired Companies” for six straight years, and \textit{Business Ethics} magazine ranked it #10 and #26 in 2001 and 2002, respectively, in its list of the “100 Best Corporate Citizens.”\textsuperscript{2731}

The year 2003, as Peter Wallison observes, “became a turning point” for the two housing GSEs, however.\textsuperscript{2732} Part of the fallout from the Enron scandal, which surfaced in late 2001, was that the ruined company’s auditor, Arthur Andersen, voluntarily surrendered its licenses to practice as Certified Public Accountants in the United

\textsuperscript{2729} \textit{Business Ethics}, “100 Best Corporate Citizens,” available at http://www.thecro.com. \textit{Business Ethics} magazine is now called the \textit{Corporate Responsibility Officer} magazine.
\textsuperscript{2731} Ibid.
\textsuperscript{2732} Peter J. Wallison, “The Evolution of a Policy Idea: How Restrictions on the Size of the GSEs’ Portfolios Became the Central Issue in Reform of Their Regulation.”
States. Arthur Andersen was found guilty of obstructing justice in June of 2002 because “it destroyed Enron Corp. documents while on notice of a federal investigation.” Prior to this development, Arthur Andersen was Freddie Mac’s auditor.

On March 6, 2002, Freddie Mac selected PricewaterhouseCoopers as its new auditor. Early the next year, in January of 2003, PricewaterhouseCoopers raised questions about whether Freddie Mac “had properly accounted for its portfolio of derivatives.” An investigation was launched shortly thereafter, one that eventually revealed that Freddie Mac “had manipulated its earnings in order to reduce reported volatility,” apparently in an effort to make its profits appear to have been growing more steadily. On June 9, 2003, the president of Freddie Mac, David Glenn, was fired after he admitted that he had altered a notebook that contained notes of business meetings, which obstructed the investigation. Freddie Mac’s two other most senior officials, CEO Leland Brendsel and CFO Vaughn Clarke, followed suit by stepping down abruptly. Ultimately, it came to light that Freddie Mac had understated its profits for years and eventually it agreed to a $5 billion restatement.

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2733 Ibid., “Regulating Fannie Mae and Freddie Mac: Now it Gets Serious.”
2736 Peter J. Wallison, “Regulating Fannie Mae and Freddie Mac: Now it Gets Serious.”
2737 Alex Berenson, “Mortgage Concern in Broad Shake-Up.”
2738 Ibid. Brendsel retired and Clarke resigned.
2739 Ibid., “Report Says Freddie Misled Investors,” The New York Times (July 24, 2003). Berenson notes that Freddie Mac “faced the uncommon problem of having profits that substantially exceeded forecasts,” which prompted the housing GSE to understate earnings for the sake of creating “a reserve of earnings for later years.” The understating of the profits also enabled Freddie Mac to closer approximate Wall Street’s forecasts, projecting the illusion of steadier growth than what was actually taking place.
2740 Bethany McLean, “The Fall of Fannie Mae.”
Fannie Mae responded to the Freddie Mac scandal with what Bethany McLean describes as “astonishing self-righteousness.”\footnote{2741} The CEO of Fannie Mae at the time, Franklin Raines, held a press conference “in which he accused Freddie of causing ‘collateral damage.’”\footnote{2742} Eager to distance itself from Freddie Mac, Fannie Mae added the following statement to its “Frequently Asked Questions” section of its website: “Fannie Mae’s reported financial results follow Generally Accepted Accounting Principles to the letter… There should be no question about our accounting.”\footnote{2743}

One of the most significant parts of this scandal was that Freddie Mac’s regulator, the Office of Federal Housing Enterprise Oversight (OFHEO), issued “a glowing report” on Freddie Mac’s accounting practices and financial statements just five days before the firing of David Glenn,\footnote{2744} deeming Freddie Mac’s internal controls to be “accurate and reliable.”\footnote{2745} This embarrassing regulatory failure prompted Congressman Richard Baker, Chairman of the House Subcommittee on Capital Markets at the time, to declare that the two housing GSEs’ “current regulatory oversight” was inadequate\footnote{2746} and ignited one of the most fascinating political struggles of the young century.

The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 created OFHEO, which was an independent office within the Department of Housing and Urban Development (HUD). Broadly speaking, the 1992 Act created two regulators for Fannie Mae and Freddie Mac. HUD was charged with “mission regulation,” or ensuring that the two housing GSEs were fulfilling the requirements of their respective chartered

\footnote{2741} Ibid.  
\footnote{2742} Ibid.  
\footnote{2743} Ibid.  
\footnote{2744} Kathleen Day and David S. Hilzenrath, “Restatement to Add Billions to Freddie Profits; Adjustment to Cover Three Years,” The Washington Post (June 26, 2003).  
\footnote{2745} Bethany McLean, “The Fall of Fannie Mae.”  
\footnote{2746} Kathleen Day and David S. Hilzenrath, “Restatement to Add Billions to Freddie Profits; Adjustment to Cover Three Years.”
missions. OFHEO, the other regulator, was designed to oversee the safety and soundness regulation of Fannie Mae and Freddie Mac, eventually establishing capital standards for them and performing regulatory audits of their operations. According to Bethany McLean, the very existence of OFHEO was, interestingly enough, an “illustration of Fannie’s political power.” OFHEO’s budget came from fees paid by Fannie Mae and Freddie Mac, enabling the latter to “effectively control” the former. McLean also calls attention to how propitious it must have been for the two housing GSEs to have OFHEO placed within the Department of Housing and Urban Development, a department that had no prior experience regulating financial markets.

To give one illustration of the ineffectiveness of OFHEO in overseeing the safety and soundness of Fannie Mae and Freddie Mac, one should consider that Federal Housing Enterprises Financial Safety and Soundness Act of 1992 required that OFHEO establish a risk-based capital rule for the two housing GSEs by December 1, 1994. The purpose of the rule was to contribute to making Fannie Mae and Freddie Mac safer financial institutions by determining the level of capital that they needed to possess in order to withstand a ten-year stress test. Significantly, the rule did not become effective until September of 2001, nearly seven years after the congressionally mandated deadline. In this light, one can begin to comprehend why Former Treasury official, Richard S. Carnell, deemed OFHEO to be a watchdog that was “hobbled, muzzled, and

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2748 Bethany McLean, “The Fall of Fannie Mae.”
2749 Ibid.
2750 Ibid.
underfed.”2751 It is in this context that OFHEO failed to identify Freddie Mac’s earnings manipulation.

Shortly after the Freddie Mac accounting scandal, OFHEO, under the leadership of director Armando Falcon, resolved to embark on a more thorough examination of Fannie Mae. Mortified by their failure to detect any malfeasance at Freddie Mac, and concerned that Fannie Mae may have also manipulated its accounting, OFHEO hired, in early 2004, the accounting firm Deloitte and Touche with Bob Maxant, the man who handled “the Enron board’s in-house investigation,” as the lead partner.2752 Later that same year, on September 17, 2004, OFHEO released a 211-page report on Fannie Mae entitled “Report of Findings to Date,” which contained allegations of accounting and management failure at the housing GSE. The report was the product of reviewing “over 200,000 documents and e-mails” and “hundreds of interviews and depositions of current and former staff at Fannie Mae.”2753 In the report, OFHEO called into question Fannie Mae’s “previously reported financial results, the adequacy of [their] regulatory capital, the quality of [their] managerial supervision and [their] overall safety and soundness.”2754 Moreover, OFHEO accused Fannie Mae of maintaining “a corporate culture that emphasized stable earnings at the expense of accurate financial disclosures.”2755

2751 Ibid.
2752 Ibid.
2754 Ibid.
A “dramatic”2756 hearing before the United States House of Representatives Subcommittee on Capital Markets, Insurance, and the Government Sponsored Enterprises took place on October 6, 2004 to discuss the findings of the OFHEO report. In the opening statement of the hearing, Chairman Richard Baker announced that he had attempted to acquire information detailing “the levels of executive compensation” at Fannie Mae, information “that had not been made public previously.”2757 Within days, Baker affirmed, Fannie Mae “made it clear that civil actions would be filed… if the information were to be released.”2758 When Baker asked Franklin Raines, the CEO of Fannie Mae at the time, about whether executive bonuses were triggered by earnings-per-share determinations, Raines, after initially responding in the affirmative, proceeded to complain of the “very small type” on the executive compensation chart that Baker presented.2759 Raines also protested that the information was “confidential” and protected “by the laws of the United States.”2760 Seemingly in an effort to avoid answering Baker’s questions about the levels of executive compensation at Fannie Mae, Raines proceeded to change the subject by stating that “earnings per share” had nothing to do with a Fannie Mae employee’s salary, nor with the fringe benefits that such an employee would receive.2761 When Baker clarified that he was not asking about salaries or fringe benefits, but of the $245 million in bonuses that was paid out at Fannie Mae between 1998 and

2756 Peter J. Wallison, “Regulating Fannie Mae and Freddie Mac: Now it Gets Serious.”
2758 Ibid.
2759 Ibid., 130.
2760 Ibid., 129.
2761 Ibid. 130.
2003, Congressman Barney Frank interrupted the inquiry and asked Baker if all of the rest of the representatives would “get this much time.”

Baker’s concern over the exorbitant bonuses being paid to executives of a company that has a public mission and receives government privileges is understandable. Yet, as Wallison correctly states, “the tenor of things in Congress was still so supportive of the GSEs that Armando Falcon… received a far more hostile reception than Raines” during the hearing. Consider, for example, the outburst of Congressman William Lacy Clay, who declared that the entire hearing was “about the political lynching of Franklin Raines.”

To further demonstrate this point, one can look at how Congressman Michael Capuano defended Fannie Mae during his interrogation of Armando Falcon. Here is a portion of their remarkable exchange:

Capuano: I guess in the normal course of events, absent different issues, and not all the time, is it not a normal circumstance where many entities within the rules of GAAP (Generally Accepted Accounting Principles), within the rules of various FAS’s (Financial Accounting Standards) and other accounting Procedures and tax procedures, try to on occasion smooth out earnings? Is that not something that happens here and there in the business world?

Falcon: If it happens, it is wrong. It is not proper to try to smooth out earnings by violating accounting rules.

Capuano: I did not say violate it. You did not hear the question. Within the rules of accounting, within the rules allowed by various regulators,

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2762 Ibid.
2763 In May of 1999, then-CEO of Fannie Mae, Franklin Raines promised investors that, over the course of the next five years, the company would double its earnings per share, having it grow by 15% each year. Please see: “Major Investor Sells Stake in Fannie Mae,” The Washington Post (March 13, 2001).
2764 Peter J. Wallison, “Regulating Fannie Mae and Freddie Mac: Now it Gets Serious.”
there are times and certain situations that it is allowed.

Falcon:  If it is within the rules of accounting, it is not improper.

Capuano: So within the rules, the concept of smoothing out earnings in and of itself is not a violation… 2766

A little later in the interrogation of Falcon, Congressman Spencer Bachus proceeded with a line of questioning that essentially amounted to a prolonged gripe over “somebody” prematurely disclosing the substance of the report to *The Wall Street Journal*, reminding Falcon that the disclosure of nonpublic information was a violation of OFHEO guidelines, and insinuating that he had not done enough to identify the party or parties that were responsible for the leak of information. 2767 Most memorable of all was Congressman Artur Davis’ interrogation, which was so forceful and accusatory that Falcon felt forced to proclaim, “We are just trying to do our job as a regulator. You can question my motives, my judgment, even my qualifications… but that will not change the contents of the report.” 2768

In a later statement, Chairman Baker said that some of the committee members “verbally assaulted” Falcon during the hearing. 2769 A congressional aide, recalling what had transpired during the hearing, said, “I have never seen anyone treated as disrespectfully as Armando Falcon was by the Democrats and by Franklin Raines.” 2770 For his part, Falcon declared that the Democrats on the committee were “so blinded by their loyalty to Fannie” that they could not see what was really happening. 2771

2766 Ibid., 71-72.
2767 Ibid., 90.
2768 Ibid., 103.
2770 Bethany McLean, “The Fall of Fannie Mae.”
2771 Ibid.
One should note that, despite the overall hostile reception of the 2004 OFHEO report by the House subcommittee, the Securities and Exchange Commission began an informal investigation of its own, intriguingly at the insistence of Fannie Mae, and it eventually vindicated both the report and Falcon. On December 15, 2004, about thirty people, including Raines, Falcon, three members of Fannie Mae’s board, representatives from two accounting firms, and Justice Department officials “piled into a conference room at the SEC headquarters in Washington D.C.” During this meeting, the SEC’s chief accountant, Donald Nicolaisen, “announced that Fannie Mae did not comply ‘in material respects’ with accounting rules, and that as a result, Fannie would have to restate its results.” Raines responded to the accusation by asking what Fannie Mae had done wrong. Nicolaisen famously answered Raines by holding up a piece of paper and stating that if “the four corners of the sheet represented what was possible under GAAP, and the center was perfect compliance... [then] ‘you weren’t even on the page.’” When Fannie Mae representatives attempted to argue that if they could not follow the principles properly then no one could, Nicolaisen responded, “Many companies out there get it right.”

In the end, the SEC concluded that Fannie Mae had violated accounting rules in its treatment of derivatives and loans, and required the housing GSE to “restate its earnings over the previous four years.” It was soon discovered that the combination of mismanagement, earnings manipulation, and unconstrained growth resulted in an estimated $10.8 billion in losses. Fannie Mae’s Board of Directors allowed Raines to

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2772 Ibid.
2773 Ibid.
2774 Ibid.
2775 Ibid.
“retire” on December 20, 2004, receiving an annual pension of $1.37 million, $5.8 million in stock options, and $8.7 million in deferred compensation to be paid through 2020.\textsuperscript{2777} After it was disclosed that Raines would be retiring, he publicly stated, “By my early retirement, I have held myself accountable.”\textsuperscript{2778} In 2007, Raines sued OFHEO for delaying his receipt of a $3.9 million stock award.\textsuperscript{2779} The Chief Financial Officer of Fannie Mae at the time, J. Timothy Howard, was fired on December 21, 2004 and he ended up receiving an annual pension of $432,852, stock options worth $4.4 million, and $4 million in deferred compensation.\textsuperscript{2780}

As it turned out, the “revelations about the GSEs’ distorted accounting… had more far-reaching effects than the dismissal of [Fannie Mae and Freddie Mac’s] top officers.”\textsuperscript{2781} One could no longer assume that the two housing GSEs were well-run institutions, which consequently underscored questions involving the risks that they posed to the economy. St. Louis Reserve President, William Poole, stated in a January 13, 2005 speech that a GSE crisis could have a tsunami-like impact on the financial markets.\textsuperscript{2782} The Comptroller General of the United States, David M. Walker, openly expressed concern over the dangers posed by Fannie Mae and Freddie Mac, stating, “I believe the evidence clearly shows that the current regulatory structure is not well-equipped to oversee the operations and effectively monitor the risks of the large and

\begin{footnotesize}
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\item[2779] Ibid., “Raines Sues OFHEO Over Stock,” \textit{The Washington Post} (July 6, 2007).
\item[2781] Peter J. Wallison, “The Evolution of a Policy Idea: How Restrictions on the Size of the GSEs’ Portfolios Became the Central Issue in Reform of Their Regulation.”
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Major media outlets, such as The Wall Street Journal, The Washington Post, and The Financial Times even “began to assign reporters to the Fannie and Freddie ‘beat.’” Over the course of one and a half years, from June of 2003 through December of 2004, Fannie Mae and Freddie Mac’s operations were no longer above suspicion.

6.8. The Failure of Congress to Reform Fannie Mae and Freddie Mac Prior to the Subprime Mortgage Crisis: Group Bias in Action

Politically, there appears to have been at least a modicum of awareness amongst some of the members of Congress that the regulation of the two housing GSEs prior to and during these scandals was inadequate. It is beyond the scope of this study to examine these bills in detail, but quick mention of them will demonstrate that, since the turn of the century, Congress did, in fact, discuss possible reforms of Fannie Mae and Freddie Mac. The first bill to appear in the 2000’s came from Congressman Richard Baker, who introduced H.R. 3703, the “Housing Finance Regulatory Improvement Act,” on February 29, 2000. Congressman Baker expressed concern at a March 22, 2000 hearing before the United States House of Representatives Subcommittee on Capital Markets, Securities, and Government-Sponsored Enterprises that eight years after the creation of OFHEO, a stress test designed for determining the capital adequacy of Fannie Mae and Freddie had yet to be implemented, despite a congressionally mandated deadline in 1994. H.R. 3703 contained provisions for establishing a single regulator for Fannie Mae and Freddie

Mac and also for eliminating their respective lines of credit with the United States Treasury Department. Although hearings were held discussing the bill, H.R. 3703 never made it to the House of Representatives for a vote.

On July 15, 2002, Congressman Ron Paul introduced a bill, H.R. 5126, to the House Committee on Financial Services. The bill was entitled the “Free Housing Market Enhancement Act” and it sought to “prohibit the provision of Federal funds to the housing-related government-sponsored enterprises and to remove certain competitive advantages granted under law to such enterprises.”2786 These “competitive advantages” included Fannie Mae and Freddie Mac’s line of credit with the United States Treasury as well as “their SEC exemption, their exemption from state and local taxes, the president’s authority to appoint five members of their board of directors… and the authority for national banks to make unlimited investments in the GSEs’ obligations.”2787 This bill was referred to the House Subcommittee on Capital Markets, but it too was never voted upon, so it failed to become a law as well.

A little over a year later and the month following the eruption of the Freddie Mac scandal, on July 31, 2003, Senator Charles Hagel, along with Senate co-sponsors Elizabeth Dole, Trent Lott, John McCain, and John Sununu, introduced a bill, S. 1508, entitled “The Federal Housing Enterprise Regulatory Reform Act of 2003.” It is worth noting that, similar to H.R. 3703, the bill aimed to establish a single, unified, strengthened regulator for Fannie Mae and Freddie Mac, eliminating the dual-regulators of HUD and OFHEO. On March 31, 2004, the day before the Senate Committee on Banking, Housing and Urban Affairs was scheduled to hold an executive session to work

2787 Peter J. Wallison, “The Fannie/Freddie Time Bomb.”
on the bill, Fannie Mae launched a television advertisement that featured “a worried looking Hispanic couple” expressing concern over the bill. The advertisement contained the following dialogue:

Man: Uh-oh.

Woman: What?

Man: It looks like Congress is talking about new regulations for Fannie Mae.

Woman: Will that keep us from getting a lower mortgage rate?

Man: Some economists say rates may go up.

Woman: But that could mean we won’t be able to afford the new house.

Man: I know.2788

The next day, on April 1, 2004, the bill passed in the Senate Banking Committee, with the Democrats unanimously opposing. With the Republicans in the Senate only holding 51 seats at the time, presumably it was anticipated that S. 190 would never pass the 60-vote cloture rule that was necessary for a Senate floor vote. Thus, the Senate never voted on the bill and S. 190 died in the 108th Congress.

A flurry of other congressional bills seeking to regulate the two housing GSEs also surfaced around the time of the Freddie Mac scandal, including H.R. 2022 (sponsored by Congressmen Christopher Shays and Edward Markey), H.R. 2803 (sponsored by Congressman Ed Royce), and H.R. 2117 (sponsored by Congressman Fortney Stark). All three bills were referred to the appropriate committees, but the House of Representatives never voted on any of them.

Senator Hagel, along with Senate co-sponsors Dole, McCain, and Sununu, reintroduced S. 190 on January 26, 2005, soon after the accounting scandal at Fannie

2788 Bethany McLean, “The Fall of Fannie Mae.”
Mae came to the surface. The bill, entitled the “Federal Housing Enterprise Reform Act of 2005,” contained many of the provisions that were found in the 2003 version, though it also required Fannie Mae and Freddie Mac to “reduce their [retained] portfolios to near zero – permitting them only to accumulate mortgages for the purposes of securitization.” On July 28, 2005, the Senate Banking Committee once again voted on S. 190, with the same end result: the bill passed, but all 9 of the Democratic Senators opposed. The Federal Housing Enterprise Reform Act of 2005 died in the 109th Congress.

Returning to the United States House of Representatives, Congressman Richard Baker once again sponsored a bill, H.R. 1461, which was entitled the “Federal Housing Finance Reform Act of 2005.” The bill was introduced to the House of Representatives on April 5, 2005. Similar to its S. 190 counterpart, H.R. 1461 aimed to reform the “safety and soundness” and “mission fulfillment” regulation of the two housing GSEs. The bill passed in the House on October 26, 2005 with a vote of 331-90. However, H.R. 1461 never received the necessary 2/3 Senate vote, so it too died in the 109th Congress.

The purpose of mentioning these bills is to establish that Congress was cognizant, at least to some extent, of the potential dangers posed by Fannie Mae and Freddie Mac before the subprime mortgage crisis erupted in 2007. Yet for any number of reasons, Congress was unable to muster the political willpower that was necessary to pass meaningful housing GSE reform legislation. In speaking in vague terms of “any number of reasons,” I am acknowledging that, in all likelihood, there were many factors that blocked congressional reform of the housing GSEs during this time period and, further, that each of those factors carried with them varying degrees of efficaciousness.

2789 Peter J. Wallison, “Regulating Fannie Mae and Freddie Mac: Now It Gets Serious.”
Congressional fear of public backlash, for instance, is one potential reason why the House of Representatives and the Senate failed to reform Fannie Mae and Freddie Mac. Ralph Nader once declared, “What makes it difficult to deal in any rational manner with Fannie and Freddie’s power is the fact that these GSEs are wrapped around a product – housing – that is right up there in the American psyche with apple pie and motherhood.”

During a June 15, 2000 hearing before the House Banking Subcommittee on Capital Markets, Securities, and Government-Sponsored Enterprises, Nader acknowledged that proponents of housing GSE reform are “immediately bombarded” with charges that they are “destroying the great American dream of home ownership” from Fannie Mae and Freddie Mac. Nevertheless, Nader added, “For far too long… Congress has played the role of an indulgent parent to the GSEs. The GSEs have long since grown beyond adolescence.” Nader’s observations have proven to be prescient and warrant a few words of elaboration.

The cultural climate in America promoted and continues to promote homeownership not only as a good, but, by and large, as an unassailable good. One of Fannie Mae’s slogans was “We’re in the American Dream Business,” while one of Freddie Mac’s was “Opening the Doors to Homeownership.” It would be difficult to deny that Fannie Mae and Freddie Mac attempted to capitalize on the value that many Americans placed on homeownership, whether in their efforts to resist legislation that they perceived to be unfavorable or in their advertisements.

2792 Ibid.
Consider this example, one that is taken from an incident that occurred in May of 2000. As mentioned before, Congressman Richard Baker introduced a bill, H.R. 3703, on February 29, 2000, which contained provisions for creating a single regulator for Fannie Mae and Freddie Mac, limiting their non-mission related investments, eliminating their lines of credit with the United States Treasury, and subjecting them to “tougher approval standards for new products and business activities.”

Congressman Baker stated that the legislation was needed because the size of Fannie Mae and Freddie Mac posed “a potential threat to taxpayers, who might be asked to bail them out if they fall into financial trouble.” It will be shown in a later section that Baker’s premonition was well founded.

Fannie Mae’s response to this legislation is telling. The Chairman and CEO Fannie Mae at the time, Franklin Raines, announced that the company was under “attack,” and the housing GSE launched an initiative that they called The Coalition for Homeownership. Prior to a House Banking Committee hearing on H.R. 3703, Fannie Mae contacted constituents in all of the districts of the committee members and purchased lists of homeowners in those areas from vendors. A telemarketing firm then called those homeowners, soliciting their opposition to H.R. 3703 measures. The Coalition for Homeownership also circulated letters to homeowners in those designated areas, suggesting that the mere scheduling of the House Banking Committee hearing on H.R. 3703 already “raised [mortgage] interest rates” and “denied homeownership to

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2797 Ibid.
206,000 families.”2798 One of the letters bluntly stated, “I hope you will fight against Congressman Baker’s bill, H.R. 3703, which would increase the cost of homeownership.”2799

Congressman Donald Manzullo, one of the members of the House Banking Committee, received over 2,000 letters from constituents in his district that had signed petitions “in support of lowering the cost of homeownership and lowering mortgage interest rates.”2800 Another member of the committee, Congressman John Sweeney, complained that his office had been “barraged by 5,000 letters, mail-grams and e-mails from Fannie Mae and the Coalition for Homeownership.”2801 When Congressman Manzullo “directed his staff to call 30 constituents whose names were on the Fannie Mae letters,” he discovered that many of the constituents “could not remember the letter or [did not] have any idea about the bill or who contacted them,” though some of them thought that a “non-profit affordable housing group” had organized the movement.2802 Congressman Manzullo eventually accused Fannie Mae of conducting a “bogus” grassroots lobbying campaign against H.R. 3703.2803 Still, the House of Representatives never voted upon H.R. 3703, so the bill never became a law.

Predictably, the good of homeownership was the centerpiece of many of Fannie Mae and Freddie Mac’s advertisements. In 1996, the Internal Revenue Service ruled that Fannie Mae’s television advertisements, like ones featuring “families or young couples struggling with housing and credit issues,” were consistent with its chartered mission of

2798 Ibid.
2799 Ibid.
2800 Ibid.
2801 Ibid.
2802 Ibid.
2803 Ibid.
increasing homeownership. One of those advertisements depicted “a woman on a bus dreaming about the wonderful life she would have if she could afford to buy the Victorian-style home she is passing on her way downtown.” Another advertisement featured “puppies gambol[ing] in the yard as families beam proudly outside new homes acquired with capital” from Fannie Mae. Advertisements of this sort were part of Fannie Mae’s “educational outreach program,” which itself was part of the Fannie Mae Foundation that was established in 1979. Though data was difficult to locate, the Fannie Mae Foundation spent approximately $43 million on advertising in 1998, $48 million in 2001, and $87.2 million in 2003 and 2004 combined. According to John McKinnon, “the Fannie Mae Foundation spends more of its money on advertising than anything else,” including its contributions to charitable organizations.

John Buckley, then-senior vice president of communications at Fannie Mae, explained that the company devotes so much money to advertising because it is “vital to us to make sure people understand that if we weren’t there, there would be higher mortgage rates and a significantly less consumer-oriented mortgage finance system.” One Freddie Mac advertisement, that appeared in the middle of July of 2000, compared the 3% mortgage downpayment it offers to its American customers to “other countries”

2804 Mary Jacoby, “Critics Question Fannie Mae’s Influence,” St. Petersburg Times (July 17, 2000).
2805 Ibid.
2807 Mary Jacoby, “Critics Question Fannie Mae’s Influence.”
2808 Ibid.
2811 John D. McKinnon, “Fannie Mae Irks Rivals With Ads By Its Foundation.”
2812 Patrick Barta, “Fannie Mae, Freddie Mac Counter Critics.”
that require their borrowers to make mortgage downpayments as high as 50%. The text of the advertisement asked, “Why are homebuyers in America so much better off?” and then proceeded to answer its own question by stating “because America has a secondary mortgage market to provide funds for home mortgages,” of which “Freddie Mac is a critical part.”

In late 1999, Fannie Mae sponsored a series of advertisements that targeted their critics, portraying them as “a cabal of anonymous executives plotting to drive up mortgage rates.” One print advertisement in particular consisted of “an overhead photo” that showed “a half-dozen people sitting around a table drinking coffee” with the caption: “Can you believe it? They’re actually organizing the Coalition for Higher Mortgage costs.” In another Fannie Mae print advertisement, “the critics are shown as dark silhouettes, furtively plotting to ‘roll back products that cut consumers’ costs’.”

The important point is that members of Congress had a powerful disincentive to pass legislation that would have strengthened the regulation of the two housing GSEs prior to the subprime mortgage crisis: perceived popular public dissent. Acting in a way that hindered how Fannie Mae and Freddie Mac conducted business ran the risk of being perceived or portrayed as impinging upon the value of homeownership and, hence, as acting against the will of American voters. Members of Congress that made the decision to show unconditional support for the housing GSEs as they were structured before the subprime mortgage crisis likely faced few, if any, immediate negative consequences.

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2813 Ibid.
2814 Ibid.
2816 Ibid.
2817 Ibid.
Indeed, congressionally supporting the housing GSEs during this time was much more likely to be politically advantageous. Nicholas Kulish and Jacob M. Schlesinger mention in a 2001 article, written in The Wall Street Journal, how Fannie Mae won “the gratitude of politicians by staging local events with them, often to ‘announce’ its plans to buy local mortgages.”2818 As the two authors note, these publicity stunts were “invaluable” for the politicians, for they were able to “bask in the glow and score points with voters.”2819 Yet, the authors call attention to the strangeness of the relationship between Fannie Mae and members of Congress, as though “Ford or Microsoft could allow politicians to gain some credit with voters for every Escort or Windows package sold in their districts.”2820 One of the unique features of Fannie Mae and Freddie Mac’s “product” is that politicians can publicly endorse homeownership without alienating any significant portion of voters. The near-universal American support for homeownership created a powerful incentive for members of Congress to avoid or delay investing any energy in reforming Fannie Mae and Freddie Mac in any substantial way prior to the outbreak of the subprime mortgage crisis. Former Congressman Jim Leach beautifully expressed the spirit of this point when he noted that Fannie Mae and Freddie Mac “put their power to use protecting their vested interest, and it so happens that their vested interest in large, but not complete, measure is the public interest.”2821

2819 Ibid.
2820 Ibid.
CEO, Franklin Raines, conveyed this point even more concisely when, in describing his company, he stated, “We are what people have asked for.”

A second potential reason for the sluggish congressional response to the need for reforming Fannie Mae and Freddie Mac is that both of the housing GSEs spent sizeable sums of money on campaign contributions and hiring lobbyists to influence legislation. In terms of campaign contributions, the two housing GSEs, along with their employees, donated over $14.6 million to the campaign funds of dozens of members of Congress between 2000 and 2008. A September 11, 2008 report, published by The Center for Responsive Politics, lists all 354 members of Congress who have received campaign contributions from Fannie Mae and Freddie Mac since the latter became a publicly traded company in 1989. The two housing GSEs and their employees were most generous over this period of time (with donations totaling $165,400) to the current Chairman of the Senate Committee on Banking, Housing, and Urban Development, Senator Christopher Dodd. Ranking Member of the House Committee on Financial Services, Congressman Spencer Bachus, as well as the Ranking Member of the Senate Committee on Banking, Housing, and Urban Affairs, Senator Richard Shelby, were also among the ten members of Congress who received the most campaign contributions from the two housing GSEs.


2823 This data is available at The Center for Responsive Politics, which can be viewed at http://www.opensecrets.org. I first came across this information by way of a September 2008 report that was published by the Common Cause Education Fund, “Ask Yourself Why… They Didn’t See This Coming,” available at http://www.commoncause.org.

during this period of time. Congressman Bachus received $103,300, while Senator Shelby received $80,000.\textsuperscript{2825}

One should further note that in April of 2006, the Federal Election Commission (FEC) fined Freddie Mac $3.8 million for violating federal campaign-finance laws. The FEC accused Freddie Mac of “using corporate resources to raise $1.7 million at political fundraisers, most of them for Republican members of Congress and many involving House Financial Services Committee Chairman Michael G. Oxley.”\textsuperscript{2826} The FEC probe of Freddie Mac’s internal documents revealed that its chief lobbyist, Mitchell Delk, organized an “orchestrated effort… to court key lawmakers through lavish dinners and other events.”\textsuperscript{2827} In the end, Delk’s effort “pumped money into the campaigns of more than 50 politicians who had direct oversight… or were considered supportive of” Freddie Mac.\textsuperscript{2828} In one particularly incriminating document, Delk wrote that over the course of holding “over 40 fundraisers” for Oxley, “[w]e [Freddie Mac] proposed to Chairman Oxley a political model that was bold and unprecedented. We offered to use our fundraising model to marry his interest as Chairman with our interest in assisting committee members supportive" of Freddie Mac's goals.\textsuperscript{2829} Another document, one that summarized Delk’s work at Freddie Mac from 2000-2003, noted that he had “held over 75 events for members of House Financial Services Committee” raising almost $3 million.\textsuperscript{2830} Of those 75 events, the document indicated, “90 percent” were held “to

\begin{footnotes}
\item[2825] Ibid.
\item[2827] Ibid.
\item[2828] Ibid.
\item[2829] Ibid.
\item[2830] Ibid.
\end{footnotes}
benefit Chairman Oxley." 2831 Ultimately, Freddie Mac agreed to the $3.8 million settlement without admitting or denying that it had broken the law. FEC also honored Freddie Mac’s request for a “global settlement,” one that would include any wrongdoings committed by the company and all of its employees. This “global settlement” enabled Freddie Mac to avoid having to pay any civil fines that potentially could have been levied against Delk, former CEO Leland Brendsel, and any other Freddie Mac employee. 2832

As for lobbying members of Congress, Fannie Mae and Freddie Mac spent over $165 million on political lobbying expenditures between 2000 and 2008. 2833 This is, at first glance, a perplexing claim. Why would two companies that are sponsored by the government, possessing numerous government privileges, spend such a large sum of money lobbying members of Congress?

In response to this question, Thomas Stanton persuasively argues that political risk, as opposed to economic risk, is the greatest threat to Fannie Mae and Freddie Mac’s survival. As Stanton states, the two housing GSEs live or die “according to the value of the benefits provided by [their] enabling legislation” 2834 instead of by “the financial acumen of their managers.” 2835 Jim Johnson, who was the Chairman and CEO at Fannie Mae from 1991 to 1998, devised two strategies to manage political risk, ones “that he believed would insure that Congress never took away Fannie’s special status.” 2836 Johnson called the first strategy “indispensability” and the second one “tangibility.” 2837 As Bethany McLean explains, “[Johnson] wanted Congress to see that America couldn’t

2831 Ibid.
2832 Ibid.
2833 This data was also provided by The Center for Responsive Politics, available at http://www.opensecrets.org.
2835 Ibid., 8.
2836 Bethany McLean, “The Fall of Fannie Mae.”
2837 Ibid.
live without Fannie Mae. And he wanted Fannie Mae to be practically synonymous with the idea of home-ownership.” In an effort to provide a concrete example of how Fannie Mae attempted to cope with “political risk,” I will present an instructive anecdote. In the summer of 1994, Congressman Pete Stark scheduled a House District Committee hearing that was designed to focus on Washington D.C.’s budget problems. Part of Stark’s legislative proposal was to eliminate the statutory tax exemptions that Fannie Mae had enjoyed in the District for the sake of raising funds for other public purposes. Notably, only one witness testified in favor of the legislation, a housing activist from Boston who was “subjected to a harsh line of questioning by Congressman Cass Ballenger, who [in turn] was lobbied by Fannie Mae and held stock in the firm for several years.”

Washington D.C. Council Chairman, David Clarke, initially supported the legislation and “intended to ask his council colleagues to vote in favor of taxing Fannie Mae.” Fannie Mae was the District’s most profitable company at the time, and its tax break was estimated to be worth approximately $300 million a year. Eliminating the tax break would have served as a “simple solution to the District’s financial crisis,” and a D.C. Council vote in favor of this measure would have sent “a strong message to Congress,” the party responsible for making “the final decision about whether to permit any new tax” on Fannie Mae. Clarke later admitted, however, that Fannie Mae was organizing people that it worked with in the District of Columbia to give him “a little bit

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2838 Ibid.
2840 Ibid.
2841 Ibid.
of heck,” so he elected not to put the matter on the council agenda.2842 Dennis Jacoby, Managing Director of the Financial Research Institute, based in Washington D.C., described Fannie Mae’s approach to blocking the legislation as an “iron fist in [a] velvet glove.”2843 I propose that this is an example of a housing GSE managing “political risk.”

In sum, since the time that Fannie Mae and Freddie Mac each came into existence, Congress has always been the only party that has had the authority to alter or eliminate any of the privileges that the GSE status conferred to the two companies. Yet, Congress was in an “uncomfortable position” when it came to regulating the two housing GSEs. Patrick Barta frames the dilemma quite well: “Do they look the other way, because of all the good that Fannie and Freddie do? Or do they rein in the companies, reducing the likelihood of future problems but also possibly driving up mortgage rates and pushing some potential homeowners out of the market?”2844 On top of potentially raising mortgage interest rates and preventing “potential homeowners” from owning a home, congressional attempts to “rein in” Fannie Mae and Freddie Mac could have had politically ruinous consequences. Before the subprime mortgage crisis erupted, Peter Wallison affirmed that Fannie Mae and Freddie Mac “were the most powerful companies in the country, and literally controlled the Congress… Congress would not do anything that they did not want Congress to do – and that came through some very sophisticated political activities and public relations that made it very difficult to challenge them.”2845

2842 Ibid.
2843 Ibid.
A 1996 Congressional Budget Office report summarized the fragile and hazardous relationship between Congress and the two housing GSEs by noting that “once one agrees to share a canoe with a bear, it is hard to get him out without obtaining his agreement or getting wet.”

Leading up to the subprime mortgage crisis, a congressional majority elected not to get the bear out of the canoe and instead idly stood by as the two housing GSEs layered excessive risk upon excessive risk until the companies imploded in the fall of 2008.

6.9. Fannie Mae and Freddie Mac: Serving Two Irreconcilable Masters and Torn Between Providing Two Sets of Particular Goods

A further pertinent question that needs to be answered is: Why were Fannie Mae and Freddie Mac so reluctant to give up any of their government-conferred privileges, whether it was their $2.25 billion line of credit with the United States Treasury Department, their state and local tax exemptions, their highly leveraged retained portfolios, or any of the other privileges enumerated above? In answering this question, it will become apparent that there is an inherent contradiction in the structure of the two housing GSEs.

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2846 Congressional Budget Office, “Assessing the Public Costs and Benefits of Fannie Mae and Freddie Mac,” 44.
2847 I am borrowing the phrase “serving two irreconcilable masters” from a text edited by Peter Wallison, Serving Two Masters, Yet Out of Control (Washington: AEI Press, 2001).
2848 During a June 15, 2006 hearing before the Senate Committee on Banking, Housing, and Urban Affairs, Acting Director of OFHEO, James Lockhart, asserted: “[Fannie Mae and Freddie Mac] have $1.5 trillion of debt outstanding, and they have used that debt to buy $1.4 trillion of assets. To hedge those assets, they have $1.3 trillion of derivatives, and on top of that they have $2.6 trillion in guarantees. And that is all built on a combined capital of only $75 billion.” United States Senate Committee on Banking, Housing, and Urban Affairs, “The OFHEO Report of the Special Examination of Fannie Mae,” 24. In 2001, it was reported in The Birmingham Business Journal that “for every $10,000 in Fannie Mae’s $1.3 trillion book of business, it has reserved only $6 to cover losses.” This information came from the article “Think Private For Housing.” The Birmingham Business Journal (May 6, 2001), available at http://birmingham.bizjournals.com/birmingham/stories/2001/05/07/editorial1.html.
In December of 2004, the CEO of Freddie Mac at the time, Richard Syron, concisely offered one explanation for why the two housing GSEs resisted congressional efforts to retract any of their government-confferred privileges:

Our critics can’t have it both ways. They can’t demand that we meet ambitious goals and at the same time strip away what makes us unique and treat us as if we were just another couple of private-sector financial institutions. Because those types of changes would make it all-but-impossible for us to serve our mission. And they would harm our partners just as they would harm the families we serve.\(^\text{2849}\)

In short, revoking any of Fannie Mae or Freddie Mac’s privileges would have, in Syron’s estimation, impaired their ability to meet the expectations of either Congress or their shareholders, or perhaps both. It is the fact that Fannie Mae and Freddie Mac “have two irreconcilable roles,” they serve “two masters,” each with conflicting objectives, which makes a reduction in or revocation of their privileges unpalatable to them.\(^\text{2850}\) On one hand, the two housing GSEs are responsible for providing the particular goods of liquidity, stability, and affordability of mortgage credit across the country, yet they also have a fiduciary duty to provide the particular good of maximizing returns to their shareholders. Two contrasting quotes by Syron nicely bring out this tension.

In his March 15, 2007 written testimony submitted to the House Committee on Financial Services, Syron speaks of the “awkward reality” of Fannie Mae and Freddie Mac regulatory reform being a “delicate balancing act.”\(^\text{2851}\) According to Syron, Freddie Mac has a “responsibility to take into account the full impact of any proposed legislation

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\(^{2850}\) Peter J. Wallison, Serving Two Masters, Yet Out of Control, 1.

on our continuing ability to fulfill our statutory mission of providing liquidity, stability, and affordability to the nation’s housing markets.” 2852 In another context, in March of 2008, Syron was asked if Freddie Mac would raise capital to increase purchases and guarantees of home loans, in effect contributing to the liquidity of the secondary mortgage market, even though those actions would lead to diluting shareholder equity in the company. Syron unwaveringly affirmed, “This company will bow to no one on our responsibility to the shareholders… As long as we are what we are, it’s clear what our fiduciary responsibility is.” 2853

During a hearing conducted by the Financial Crisis Inquiry Commission in April of 2010, former Fannie Mae CEO, Daniel Mudd, reflected on this tension. Mudd affirmed, “On one hand, without revenue and profits and growth, [Fannie and Freddie] could not attract global capital to the U.S. housing market. And on the other hand, without meeting the mission goals for affordable housing and liquidity, [Fannie and Freddie] could not meet the requirements of their congressional charter.” 2854 Mudd proceeded to claim that the GSEs “could not do what a private firm could do” once the mortgage market deteriorated, for they “had to stay in the market [and] provide liquidity.” 2855

In the event that a given piece of legislation is needed to help Fannie Mae and Freddie Mac satisfy the demands imposed by their federal charters – yet that same piece of legislation is anticipated to have a negative impact on the housing GSEs’ shareholders – what are Fannie Mae and Freddie Mac to do? Alternately put, what if Fannie Mae and

2852 Ibid., 12.
2855 Ibid.
Freddie Mac grasp that moving forward with a given course of action will likely benefit their shareholders, but simultaneously detract from their efforts to provide liquidity, stability, and affordability to the domestic housing market?

June O’Neill, over ten years before the emergence of the subprime mortgage crisis, understood the nuances of this difficulty and provided a wonderful analogy to draw out its complexity:

Of course we have food stamps. But suppose instead that we said the way we are going to provide subsidized food to low income people in the District of Columbia is to give a subsidy to Giant and Safeway [the two dominant food retailers] and expect them to pass it on. Well, they would be in a quandary. They would be getting this subsidy that would enable them to be more profitable. What would they do with it?… I think everyone would easily see that it is an inefficient thing to do. That is sort of what we have been doing with Fannie Mae and Freddie Mac in terms of requiring them to do additional good deeds and try to subsidize low income populations.2856

The “additional good deeds” that O’Neill mentions could also include those mandated tasks to provide stability and liquidity to the secondary mortgage market. The issue at stake, then, is that Fannie Mae and Freddie Mac are the recipients of an opaque federal subsidy and, further, every dollar of the subsidy that they use to fulfill the requirements of their charters is potentially one less dollar that could be passed along to their shareholders, or retained by executives, or utilized for any other non-mission related purpose.

Taking this argument one step further, when one juxtaposes the chartered mission-related goals (providing stability, liquidity, and affordability of mortgage credit) with the shareholder-related goal (generating a profit to maximize returns to

shareholders), the primacy of the latter becomes apparent. Assuming that the federal government is not implicitly standing behind Fannie Mae and Freddie Mac’s debt obligations,\textsuperscript{2857} then if the two housing GSEs are unprofitable companies over time, they will become insolvent and unable to proceed with either of their lines of business. In such a scenario, not only would Fannie Mae and Freddie Mac fail to maximize returns to their shareholders, they would also be unable to continue to buy-and-hold mortgages and mortgage-backed securities for their retained portfolios or provide guarantees on their mortgage-backed securities to investors. The upshot is that sustained profitability is a necessary precondition, absent the implied federal government guarantee of their debt obligations, for the two housing GSEs to successfully meet their mission-related goals. Without being profitable companies, Fannie Mae and Freddie Mac would eventually be unable to provide stability, liquidity, and affordability of mortgage credit across the country.

To return to June O’Neill’s point, subsidizing private companies to provide public goods is an inefficient use of resources because a private companies’ provision of those public goods will necessarily be a secondary concern. Every dollar of the subsidy that is spent on bringing about the designated public goods is a dollar that could have been spent making the company more profitable. Perhaps there can be some overlap between the two goods (a private company that spends subsidized money in a certain way for the sake of bringing about a public good, also results in turning a profit for the company), but it is hard to rectify, consistently and over time, the underlying tension between government-

\textsuperscript{2857} In light of the Obama Administration’s Christmas Eve 2009 decision to offer unlimited financial assistance to Fannie Mae and Freddie Mac in their efforts to meet their debt obligations, this assumption is simply untenable.
mandated public-spiritedness and private company profit-seeking, especially when the latter must take precedence over the former in the sense that was just explained.

With this thought in mind, it is important to reflect upon Peter Wallison’s observation that “the contradiction between performing a government mission and serving the interests of private shareholders [is] obscured” when the housing market is growing and housing prices are rising.\textsuperscript{2858} More specifically, I think the fundamental tension that was masked as the housing market was expanding and housing prices were increasing was between the two housing GSEs’ felt urgency for chasing profitability and their responsibility to create conditions for a stable secondary mortgage market. The two other government mission-related objectives of providing liquidity to the secondary mortgage market and making mortgage credit more affordable nicely harmonize with the objective of maximizing returns to shareholders. As long as the two housing GSEs could continually churn out profits, they could consistently be in a position to provide a favorable rate of return to shareholders as well as appear to be credible issuers of bonds to investors.\textsuperscript{2859} Profitability, likewise, ensured that there would be a steady incoming stream of investor capital targeted at Fannie Mae and Freddie Mac’s bonds and guaranteed mortgage-backed securities, which would contribute to making the secondary mortgage market more liquid: more readily available capital for a traditionally illiquid product (home mortgage loans). The other government mission-related objective, making mortgage credit more affordable, is also well-served by profitability. Regardless of whether the two housing GSEs actually allocated some of their profits for lowering

\textsuperscript{2858} Peter J. Wallison, “Private Profits, Public Risks.”
\textsuperscript{2859} Of course, the perceived implicit federal government guarantee of Fannie Mae and Freddie Mac’s debt obligations also contributed to the two housing GSEs’ profitability.
mortgage interest rates,\textsuperscript{2860} being profitable firms certainly would not hinder their efforts to do so.

The government mission-related objective of bringing stability to the secondary mortgage market, however, differs from the other two mission-related objectives in that it inherently carries with it a peculiar element of restraint. Profitability, liquidity, and affordability alone are incapable of creating conditions for a stable secondary mortgage market. Stability, among other things, requires one to consider how sustainable one’s business operations are both in the present and future. Preserving a stable secondary mortgage market entails looking not only at the current and short-term profitability of Fannie Mae and Freddie Mac, but also at their long-term profitability. A commitment to a stable secondary mortgage market would place reasonable limits on the affordability of mortgage credit. Finally, a stable secondary mortgage market would obviously need to be liquid, but would also entail having prudential measures in place to perpetuate that liquidity. Without a stable secondary mortgage market, Fannie Mae and Freddie Mac would be unable to meet those three goals. I propose that the gradually intensifying \textit{instability} of the secondary mortgage market, the market of which Fannie Mae and

\textsuperscript{2860} It is interesting that the term “affordable” came to be equated with “obtaining a home mortgage with a low mortgage interest rate.” Intuitively, this makes a certain amount of sense because the lower the mortgage interest rate, the lower the monthly mortgage payment will be. To the extent that monthly mortgage payments are lowered, more people will be able to afford making those payments. This is especially true if lenders do not require a down payment of, say, 20%. However, making homeownership more affordable in this sense contributed to an 85% increase in home prices from 1997 to 2006 alone. Defining the term “affordable” in this way also overlooks the fact that some of these mortgages with low interest rates are not fixed-rate mortgages. One could obtain an “affordable” adjustable-rate mortgage with an initial low interest rate, but then suddenly be responsible for making \textit{unaffordable} monthly mortgage payments when one’s mortgage resets at a higher rate. My concern is that homeownership could increase (more people could attain a mortgage) without that good actually being more affordable for at least some of the homeowners. When something is genuinely affordable, it seems to me, one is able to pay for the \textit{entire} amount of that thing, whether all at once or over time, without substantially hindering one’s ability to pay for the rest of one’s expenses. Merely being approved for a home mortgage does not necessarily mean that the home is affordable. Please see: John Christoffersen, “Economist: U.S. Housing Slump May Exceed Depression,” \textit{Business News} (April 22, 2008).
Freddie Mac were stewards, was hidden when the housing market was growing and home prices persistently increased. The recent decline in home prices, according to two prominent national home price indices, supports this claim.

The Standard & Poor's/Case-Schiller National Home Price index, which is a composite of single-family home price indices for the nine United States Census divisions, reached a peak in the second quarter of 2006 and continued to decline through the first quarter of 2009. Another significant home price index, the Federal Housing Finance Agency House Price Index (FHFA HPI), which used to be called the OFHEO Housing Price Index, did not report a quarterly decline in home prices until November 29, 2007, which was the first quarterly decline in the index in thirteen years.

As of May 2010, the S&P/Case-Schiller index remains above that low point in 2009, but after a 6.5% increase in home prices over the second and third quarters of 2009, the index has since dropped 4.2%. As for the FHFA HPI, housing prices dropped 8.2% in 2008, the worst devaluation of American real estate since the 1930’s, and as of March 2010, the index is 13.2% below its peak in April of 2007. One may wonder if Fannie Mae and Freddie Mac have been able to continue their delicate balancing act,

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2865 Timothy R. Homan and Courtney Schlisserman, “Housing Prices in 20 U.S. Cities Fall a Record 18.5%,” Bloomberg L.P. (February 24, 2009).
satisfying the demands of both its shareholders and members of Congress, since housing prices began to drop.

With respect to Fannie Mae and Freddie Mac’s stock price, on May 26, 2010 shares of Fannie Mae common stock were selling for $0.95 a share, while shares of Freddie Mac common stock were selling for $1.21 a share. Looking back over the previous five years, the highest price for shares of Fannie Mae’s common stock was $70.57, while that of Freddie Mac was $71.92.2867 Thus, Fannie Mae’s shares on that day were 98.65% below its five year high, while Freddie Mac’s shares were 98.32% below its five year high. I am not implying that the aforementioned drop in housing prices directly caused those stock losses.2868 Rather, I want to call into question just how well the two housing GSEs maximized returns to their shareholders in the midst of adverse housing conditions. Referring to Fannie Mae and Freddie Mac, Thomas Stanton argues that a period of “apparently high profits can mask the emergence of conditions that will cause financial distress.”2869 As long as the two housing GSEs could still find ways to produce profits, the systemic risk that they posed to the economy could be rationalized away, ignored, or denied altogether.2870

2867 In terms of examining the prices of Fannie Mae and Freddie Mac’s common stock, I acknowledge that both a 5 year look-back period and the date of May 26, 2010 are arbitrary dates. However, for the sake of discussing the dramatic loss in value of Fannie Mae and Freddie Mac’s common stock since the emergence of the subprime mortgage crisis, these dates suffice for that purpose. I am not attempting to provide a detailed, historical analysis of the highs and lows of their respective common stock prices. I acquired the information on the prices of their common stock from Morningstar’s website, available at http://www.morningstar.com.

2868 Of course, the decline in house prices certainly contributed to those losses.

2869 Government-Sponsored Enterprises: Mercantilist Companies in the Modern World, 47.

2870 For example, Joseph E. Stiglitz, a Nobel Prize winning professor at Columbia University’s Business School, along with Jonathan E. Orszag, and Peter R. Orszag, were commissioned by Fannie Mae and published a paper in March of 2002 in which they examined the adequacy of Fannie Mae and Freddie Mac’s risk-based capital standard. They conclude their paper by noting, “This analysis shows that, based on historical data, the probability of a shock as severe as [the one] embodied in the risk-based capital standard is substantially less than one in 500,000 – and may be smaller than one in three million. Given the low probability of the stress test shock occurring, and assuming that Fannie Mae and Freddie Mac hold
As for the “mission” portion of their business, Fannie Mae and Freddie Mac were placed into conservatorship on September 8, 2008, “one of the most sweeping government interventions in private financial markets in decades.” The FHFA was named the two housing GSEs’ conservator, who has “full powers to control the assets and the operations of the two firms.” As outlined by James Lockhart, the Director of the FHFA, some of the “key components” of the conservatorship included the ousting of the Fannie Mae and Freddie Mac CEOs at the time, the suspension of dividend payments to their shareholders owning common and preferred stock, and the cessation of all lobbying expenditures.

Initially, part of the conservatorship arrangement also included the two housing GSEs each receiving a $100 billion line of credit with the United States Treasury Department, far more than their previous $2.25 billion lines of credit, which permanently removed any lingering doubts over whether the federal government was, all along, implicitly guaranteeing their debt obligations. On February 18, 2009, the Obama

sufficient capital to withstand that shock, the exposure of the government to the risk that the GSEs will become insolvent appears quite low.” Joseph E. Stiglitz, Jonathan E. Orszag, Peter R. Orszag, “Implications of the New Fannie Mae and Freddie Mac Risk-based Capital Standard,” Fannie Mae Papers, Vol. 1, No. 2 (March 2002), 6. Italics mine.

2871 Zachary A. Goldfarb, David Cho, and Binyamin Appelbaum, “Treasury to Rescue Fannie and Freddie; Regulators Seek to Keep Firms’ Troubles From Setting Off Wave of Bank Failures,” The Washington Post (September 7, 2008).


2874 On October 24, 2012, the United States Justice Department filed a civil complaint against Bank of America for allegedly defrauding Fannie Mae and Freddie Mac from 2007 to 2009. As Jonathan Weil astutely observed, “Prosecutors are suing under a statute called the False Claims Act, which imposes liability on those who defraud the federal government. Curiously, the suit is seeking damages for acts that Countrywide Financial Corp. committed before Fannie and Freddie were seized by the government -- back when U.S. officials were adamant that Fannie and Freddie didn’t have any implicit government guarantee.” Jonathan Weil, “The Oddest Revelation From the Bank of America Fraud Suit,” Bloomberg News (October 26, 2012), available at http://www.bloomberg.com/news/2012-10-26/the-oddest-revelation-from-the-bank-of-america-fraud-suit.html. Weil rightly wonders how Bank of America (which purchased Countrywide in July of 2008) could be sued for defrauding the federal government prior to September of 2008, since
Administration announced that it would double its commitment to Fannie Mae and Freddie Mac, providing them each with $200 billion lines of credit with the Treasury Department.\footnote{Binyamin Appelbaum, “U.S. Doubles Fannie, Freddie Backing to $400 Billion,” The Washington Post (February 19, 2009).} Near the end of that same year, on December 24, 2009, the Obama Administration removed the $400 billion cap and promised \textit{unlimited} emergency financial assistance to the two housing GSEs.\footnote{Zachary A. Goldfarb, “U.S. Promises Unlimited Aid to Mortgage Giants,” The Washington Post (December 25, 2009).} As of May 2010, Fannie Mae and Freddie Mac have received $137.5 billion in aid from the federal government, with both companies recently requesting a total of $19 billion more in federal assistance.\footnote{Binyamin Appelbaum, “Fannie Mae Asks For Aid at Bad Time for Obama; Republicans Use Request to Push Overhauling U.S. Mortgage Giants Quickly,” The International Herald Tribune (May 12, 2010).}

The losses that Fannie Mae and Freddie Mac have endured since the latter half of 2008 can be described as staggering. Over the course of the third and fourth quarters in 2008, the two housing GSEs reported a combined $103.1 billion in losses.\footnote{Zachary A. Goldfarb, “Fannie Loses $23 Billion, Prompting Even Bigger Bailout; Chance of Repaying Taxpayers is Slim,” The Washington Post (May 9, 2009); Zachary A. Goldfarb, “Freddie Mac Loses $10 Billion for Quarter; Mortgage Giant’s Bailout Tops $50 Billion,” The Washington Post (May 13, 2009); Nick Timiraos, “Fannie Seeks $10.7 Billion From Treasury After Big Loss,” The Wall Street Journal (August 6, 2009). Timiraos reports that Fannie Mae lost $14.8 over the course of the second quarter of 2009; Zachary A. Goldfarb, “Freddie Mac Reports Profit; Mortgage Giant Says It Won’t Tap Treasury for More Aid,” The Washington Post (August 8, 2009). Goldfarb reports that Freddie Mac, oddly enough, posted a profit of $768 million in the second quarter of 2009.} Combined, both of the housing GSEs recorded losses of over $47 billion during the first two quarters of 2009,\footnote{Zachary A. Goldfarb, “Fannie’s Red Ink Prompts U.S. Aid; Mortgage Firm Lost $59 Billion in 2008,” The Washington Post (February 29, 2009).} and losses totaling $49.4 billion over the third and fourth quarters of
2009. As for the first quarter of 2010, the most recent earnings report that has been submitted by the two housing GSEs, Fannie Mae posted a loss of $11.5 billion, while Freddie Mac reported a loss of $6.7 billion. Adding these figures together, Fannie Mae and Freddie Mac have lost a total of $217.7 billion since the third quarter of 2008.

On June 16, 2010, the New York Stock Exchange announced that Fannie Mae would be delisted from the exchange due to the fact that their shares fell below $1 for over 30 straight days, which was a violation of the NYSE’s listing requirements. The FHFA, in response to this announcement, ordered Freddie Mac to delist from the exchange as well. Both stocks were relegated to trading “on relatively obscure over-the-counter stock markets” once the delisting takes place. The magnitude of these losses suggests that regardless of how well Fannie Mae and Freddie Mac met the objectives of maximizing returns to shareholders, providing liquidity to the secondary mortgage market, and making mortgage credit more affordable, they emphatically failed to create a lasting, stable secondary mortgage market.

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2882 David Cho, “Fannie, Freddie Ordered to Delist Shares from NYSE; Regulator Says Action is No Reflection on Firms’ Performance, Direction,” *The Washington Post* (June 17, 2010).
6.10. The Collapse of Fannie Mae and Freddie Mac

Having mentioned that Fannie Mae and Freddie Mac are on “life support,” having been placed into conservatorship with an impending delisting of their shares from the NYSE, posting incredible quarterly losses, and essentially only being able to operate because of infusions of cash that have been injected by the federal government, it is now necessary to put forth the two most salient reasons why their financial downfall has occurred. After briefly introducing both of these explanations, I will unpack and examine them in greater detail in the next section.

First, then, the most prominent explanation for the near-demise of Fannie Mae and Freddie Mac can be stated this way: the combination of their fiduciary duty to maximize returns to shareholders, the enthusiastic public and political support for the value of homeownership, and the investor-perceived implicit federal government guarantee of their debt obligations created conditions in which the growth of the two housing GSEs outpaced consumer demand for conventional, 30-year, fixed-rated mortgages. The unacceptable prospect of becoming less profitable companies prompted Fannie Mae and Freddie Mac to take on more risk, both by possessing dangerously large mortgage-related obligations, eventually totaling $5.5 trillion, “almost half of all residential mortgage debt outstanding,” and by electing to enter into the subprime mortgage market. The implicit government guarantee of their obligations made the financing for those ventures possible.

The second explanation for the enormous losses that the two housing GSEs have experienced stems from the affordable housing goals that Congress thrust upon them. In

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effect, Congress required Fannie Mae and Freddie Mac to enter into the subprime mortgage market as part of their chartered mission to make mortgage credit more affordable to Americans. Depending upon how this explanation is rendered, the housing GSEs reluctantly, or at least dutifully, entered into the subprime mortgage market and bore greater risks because Congress stipulated that they do so. Both of these explanations need to be developed more fully and examined more carefully.

As a way of approaching the argument that Fannie Mae and Freddie Mac’s growth surpassed the consumer demand for conventional, 30-year, fixed-rate mortgages, and thus led to a profit-driven initiative to take on greater risks, one should note that from 1982-1994, the American homeownership rate was approximately 64%. From 1994-2000, this homeownership rate increased over 3% to 67.5%. Then, from 2000-2006, there was yet another increase in the homeownership rate, an increase of 1.7% to 69.2%. One of the more significant features of this two decade-plus increase in American homeownership is that from 2001-2006, conventional mortgage originations sharply dropped, from 57.1% of all mortgage originations in 2001 to 33.1% in 2006.

Although there was an increase in the percentage of Americans that owned a home during this time, there was eventually a marked decrease in the percentage of homeowners who were receiving conventional mortgages.

It is necessary to pause for a moment and recall that Fannie Mae and Freddie Mac’s area of expertise was purchasing single-family mortgages with origination

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2887 I am not suggesting that this was, without qualification, a beneficial development. In 1987, Professor Edwin S. Mills argued that there already was “25% too much housing” in America. Mills, “Dividing Up the Investment Pie: Have We Overinvested in Housing?” *Federal Reserve Bank of Philadelphia Business Review*, (March/April 1987), 21.
balances within the conforming loan limit, securitizing these mortgages, and then either issuing them to investors with guarantees, or holding them in their retained portfolios. If conventional, conforming mortgage originations dropped approximately 42% from 2001 to 2006, one could anticipate that this decline would impact their profitability. Neither company once posted an annual loss from 2001 to 2006, though Fannie Mae’s profits peaked in 2003 and Freddie Mac’s profits topped out in 2002. Looking at Fannie Mae’s yearly profits beginning in 2001, the company announced that it had made $5.89 billion in 2001, $4.62 billion in 2002, $7.9 billion in 2003, $4.98 billion in 2004, $6.29 billion in 2005, and $4.1 billion in 2006. Freddie Mac reported that it made $4.15 billion in 2001, $5.76 billion in 2002, $4.82 billion in 2003, $2.83 billion in 2004, $2.13 billion in 2005, and $2.21 billion in 2006.

Each year, from 1995 to 2000, both Fannie Mae and Freddie Mac reported profits that were higher than the previous year’s earnings. Fannie Mae made $2.1 billion in 1995, $2.7 billion in 1996, $3.06 billion in 1997, $3.42 billion in 1998,
$3.91 billion in 1999, 2904 and $4.45 billion in 2000. 2905 Freddie Mac, meanwhile, made $1.1 billion in 1995, 2906 $1.243 billion in 1996, 2907 $1.395 billion in 1997, 2908 $1.7 billion in 1998, 2909 $2.22 billion in 1999, 2910 and $2.55 billion in 2000. 2911 Armando Falcon, former director of OFHEO, testified that, since the early 1990’s, “Freddie Mac promoted itself to investors as Steady Freddie, a company strong in profits, and developed a corporate culture that placed a very high priority on achieving such results.”

One can reasonably assume that specializing in one product, conforming residential mortgages, and posting year over year gains from at least 1995 to 2001 caused Fannie Mae and Freddie Mac a significant amount of consternation. After all, there are, of course, a limited number of Americans who can qualify for a conventional conforming mortgage. If an individual decides to purchase a home and the amount of the mortgage exceeds the conforming loan limit, that person cannot receive a conforming mortgage. Moreover, a borrower must meet certain down payment, income verification, and credit score requirements in order to qualify for such a mortgage. This is a significant point because evidence suggests that Fannie Mae and Freddie Mac were unable to sustain their prodigious profitability by limiting their business to the conforming residential mortgage market alone. I will now examine two pieces of evidence that support this claim.

2903 Ibid.
2905 Ibid.
2908 Ibid.
2910 Ibid.
One piece of evidence surfaced during a December 9, 2008 hearing before the House of Representatives’ Committee on Oversight and Government Reform. Congressman John Tierney, as part of his interrogation of then-Fannie Mae CEO Daniel Mudd, presented a document that was found in Fannie Mae’s internal files. The title of the document was “A single family guarantee business facing strategic crossroads.”\(^\text{2913}\) It was dated in June of 2005 and, as Tierney states, was listed as “confidential” and “highly restricted.”\(^\text{2914}\) One of the headings of the document was: “The risk in the environment has accelerated dramatically.”\(^\text{2915}\) Underneath the heading, listed in bullet-points, was recognition that there had been “a proliferation of higher-risk alternative mortgage products… a growing concern about housing bubbles… a growing concern about borrowers taking on increased risk and higher debt, and lenders… [having] engaged in aggressive risk layering.”\(^\text{2916}\) Additionally, there is also mention in the document of “the growth in adjustable-rate mortgages” continuing at “an aggressive pace,” as well as “emphasis on the lowest possible payment” and homes “being utilized more like an ATM.”\(^\text{2917}\)

With this acknowledgement of the heightened risk that was circulating throughout the mortgage business at the time, the document continues: “We are at a strategic crossroads, and we face two stark choices. One is stay the course, and the other is meet the market where the market is.”\(^\text{2918}\) The benefits of staying the course, of focusing on “the more secure fixed-rate mortgages” were, according to the document, that Fannie


\(^{2914}\) Ibid.

\(^{2915}\) Ibid.

\(^{2916}\) Ibid.

\(^{2917}\) Ibid.

\(^{2918}\) Ibid., 61.
Mae would maintain its “strong credit discipline, it would protect the quality of the book, it would intensify [its] public voice on concerns about the housing bubble and accelerating risk, and, most importantly, it would preserve capital.”2919 The benefits of meeting the market where the market is, conversely, were that Fannie Mae would be able to “meet current consumer and customer demands for alternative mortgage products” and consequently would be able to take advantage of “a revenue opportunity and a growth area.”2920 The document also lists the downsides of both courses. If Fannie Mae stays the course, they would “have lower revenues and slower growth,” but if they meet the market where it is they would “have increased exposure to unknown risks.”2921 The final quote that Congressman Tierney read from the document was portentous: “If we do not seriously invest in these underground-type efforts [to dedicate resources and funding to develop a subprime infrastructure], we risk becoming a niche player, becoming less of a market leader, and becoming less relevant to the secondary market.”2922

Congressman Tierney did an admirable job summarizing the information in the document by declaring, “Based on these slides, Mr. Mudd, you faced a fundamental decision in 2005: Do you keep your focus on the more secure fixed-rated mortgages but potentially lose out on some profits, or do you compete with private lenders by entering into riskier sectors of the market?”2923 One needs to note, however, that Fannie Mae and Freddie Mac were not confronted by this “fundamental decision” in 2005. Before the term “subprime” began to carry with it strong negative connotations, Fannie Mae and Freddie Mac both publicly stated on multiple occasions that they were making efforts to

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2919 Ibid.
2920 Ibid.
2921 Ibid.
2922 Ibid.
2923 Ibid.
move into the subprime market in the late 1990’s. At a September 30, 1999 news conference, for instance, then-CEO of Fannie Mae, Franklin Raines, announced “a new product” called the “Timely Payment Rewards Mortgage,” which would allow the housing GSE “to enter the subprime market.”2924 Raines further indicated at this same press conference that Fannie Mae “plans to use the product to target half of all the subprime market.”2925 In an astonishingly prescient article, Steven Holmes, writing for *The New York Times*, warned in late September of 1999:

> In moving, even tentatively, into this new area of lending, Fannie Mae is taking on significantly more risk, which may not pose any difficulties during flush economic times. But the government-subsidized corporation may run into trouble in an economic downturn, prompting a government rescue similar to that of the savings and loan industry in the 1980's.2926

Almost exactly nine years later, Holmes’ premonition came to fruition when the two housing GSEs were placed into conservatorship.

Another example of the two housing GSEs late-1990’s immersion into the subprime market can be gleaned from an announcement made by then-Freddie Mac CEO, Leland Brendsel. In October of 1997, Brendsel revealed that Freddie Mac would begin purchasing the least risky kind of subprime loans by the end of the year and, further, that they would start buying even riskier subprime loans by the end of 1998 or early 1999.2927 Earlier that same year, Freddie Mac purchased and guaranteed a $227 million pool of

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2925 Ibid., 14.
4,300 subprime mortgages.\textsuperscript{2928} A June 24, 1997 article in \textit{The American Banker} had the headline: “Split Over Subprime Push by Fannie, Freddie; Smaller Lenders Enthusiastic; Specialists See a Competitive Threat.”\textsuperscript{2929} Heather Timmons opens her September 29, 1997 article in \textit{The American Banker} by writing, “It’s only a matter of time before Freddie Mac and Fannie Mae dominate the subprime mortgage market. At least, that was the opinion of lending executives at the Subprime ‘97 conference here last week.”\textsuperscript{2930} Although Fannie Mae and Freddie Mac were unquestionably confronted by a decision to enter into the riskier subprime mortgage market or remain in the safer conventional mortgage market, both firms arrived at this “strategic crossroads” well before 2005.

There is a second piece of evidence that supports the claim that Fannie Mae and Freddie Mac reached a point where they were longer able to confine themselves entirely to the conventional conforming mortgage market and simultaneously remain profitable. The two housing GSEs had, in the late 1990’s and early 2000’s, already forayed “into other areas of the financial economy,” engaging in what has come to be known as “mission creep.”\textsuperscript{2931} As Robert P. Cochran, former CEO of Financial Security Assistance, noted in a 1997 \textit{New York Times} article, “They’ve grown so large that they cannot put all of their capital to work and expand their base without reaching out into others parts of the market.”\textsuperscript{2932} In 1999, as reported by \textit{The White House Bulletin}, the Board of Directors of the Financial Services Roundtable (FSR) released “a new resolution addressing [the]
government sponsored enterprises.”

Part of the resolution expressed concern that “Fannie Mae and Freddie Mac have current and planned activities beyond their core missions including: providing liquidity for home equity and subprime loans; undertaking investment portfolio activities beyond housing as well as housing related investments that increase risk; creating consumer financial services ‘accounts’ tied to mortgages; [and] undertaking real estate disposition activities.” It would be germane to provide a few specific examples of Fannie Mae and Freddie Mac’s “mission creep,” and I will offer three of them.

On September 14, 1999, then-CEO of Fannie Mae, Franklin Raines, revealed at a Merrill Lynch Investor’s conference that “one of the ways Fannie would increase its market share there was by purchasing home equity loans.” At the same conference, Raines further stated, “Another way we’re going to expand the mortgage debt market is to help consumers capitalize on the equity in their homes for things they need, whether it’s reverse mortgages to finance retirement, or home equity loans to expand or improve their homes.” Raines eventually made good on his promise, as Fannie Mae began to buy unsecured home equity loans, funded by Chevy Chase Bank of Maryland, “to buyers of siding, roofing, or windows at Home Depot Inc.” In fact, a November 8, 1999 article in Asset Sales Report indicated that Fannie Mae and Freddie Mac were “already

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2933 “Roundtable Announces Resolution on GSEs,” The White House Bulletin (September 23, 1999).
2934 Ibid.
2936 Ibid.
major buyers” of home-equity loans.\textsuperscript{2938} Even a spokesman for Freddie Mac, Douglas Robinson, conceded in the article that Freddie Mac had been “a buyer of home-equity loans for awhile,” justifying the venture on the grounds that the loans “support our mission and mortgage assets.”\textsuperscript{2939} But, as Wallison, Stanton, and Ely observe, home improvement loans are a type of consumer lending and, subsequently, do not fall within the range of the housing GSEs’ charter-permitted activities.\textsuperscript{2940}

A second variety of Fannie Mae and Freddie Mac’s “mission creep” is their lending to “developers of apartment housing, including luxury housing,”\textsuperscript{2941} and the purchasing of non-single family conventional, residential mortgages. For instance, on December 9, 2002, Freddie Mac purchased a “$140 million mortgage from HSBC Bank USA to finance The Caroline, a mixed-use property located in the Chelsea section of Manhattan.”\textsuperscript{2942} The Caroline houses “431 dwelling units, 105,000 square feet of retail and a 278-car parking garage” and includes “a 12,000 square foot landscaped private roof deck and formal landscaped European garden with Carrera statuary, indoor valet parking, maid and valet services, linen service, [and] room service from first class dining establishments” located on the premises.\textsuperscript{2943} The building also includes a 44,000 square foot New York Health and Racquet Club and “a 50-foot sky lit swimming pool.”\textsuperscript{2944} It is doubtful that this investment or other investments in apartment housing or commercial real estate serve the housing GSEs’ federally chartered missions. Rather, I think that this

\textsuperscript{2939} Ibid.
\textsuperscript{2941} Ibid., 11.
\textsuperscript{2943} Ibid.
\textsuperscript{2944} Ibid.
supports Congressman Richard Baker’s assertion in 2002 that “the gorilla has outgrown the cage.”

Undoubtedly, the most alarming form of “mission creep” is Fannie Mae’s successful efforts to attain patents that are altogether unrelated to its chartered mission. Patent No. 6,904,336 was filed with the United States Patent and Trademark Office on November 8, 2002 and issued on June 7, 2005 to Fannie Mae and CO2e.com, LLC. The name of the patent is “System and Method for Residential Emissions Trading,” and former CEO Franklin Raines is credited as being one of the inventors. According to the patent’s abstract, the invention “is directed to a method of residential emissions trading and a residential emissions trading commodity.” In an April 20, 2010 article in The Washington Examiner, Barbara Hollingsworth argues that the patent “covers both the ‘cap’ and the ‘trade’ parts of Obama’s top domestic energy initiation, [and] gives Fannie Mae proprietary control over an automated trading system that pools and sells credits for hard-to-quantify residential carbon reduction efforts… to companies and utilities that don’t meet emission reduction targets.” Of the many significant ethical issues that accompany Fannie Mae’s ownership of this patent, I want to note in passing that it pursued this patent while receiving government privileges that were intended to be used for fulfilling a public mission.

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2945 Thomas Fogerty, “Critics: Fannie, Freddie Grip Mortgage Market.”
2946 Information on this patent was found on the United States Patent and Trademark Office website, available at http://www.uspto.gov.
2948 For example, if legislation happened to be passed that created “an artificial, government-mandated, trillion-dollar carbon trading market,” then the price of energy would likely rise, “indirectly making housing more expensive” and conflicting with the affordability component of Fannie Mae’s chartered mission. Please see: Barbara Hollingsworth, “Fannie Mae’s Owns Patent on Residential ‘Cap and Trade’ Exchange.”
A few months before filing for this patent, on April 3, 2002, Fannie Mae filed for another patent with the United States Patent and Trademark Office, No. 7,089,503, titled “Mortgage Loan Customization System and Process.” This patent is for a “computerized mortgage loan system” that enables borrowers “to design mortgage loans that meet their particular individual needs and financial goals.” Some critics contend that “the patent has as its purpose the improvement of loan origination, [which is] a function that it prohibited by the Fannie Mae Charter Act.” Moreover, the patent “applies to all loans (auto, credit cards, commercial, etc.), not just mortgage loans” and further applies to “all loans originated, not just those loans that Fannie Mae decides to guaranty and/or purchase for their own portfolio.” The patent’s broad applicability elicited concerns from The Mortgage Bankers Association that the “mere existence of the patent [could] stifle innovation in the lending industry, thus harming consumers and diminishing secondary market competition,” while being “at odds with Fannie Mae’s secondary market mission and government-sponsored status.”

These three forms of “mission creep,” along with the evidence cited above from the December 9, 2008 hearing before the House of Representatives’ Committee on Oversight and Government Reform, support the argument that Fannie Mae and Freddie Mac’s growth Outpaced the consumer demand for conventional mortgages and threatened

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2951 Ibid., 5.

2952 Ibid., 8.

the future stability and profitability of both companies. As a result, both companies were
compelled to expand outside of the secondary market for conventional mortgages and
attempted to earn profits in other ways, including the decision to enter into the far riskier
subprime mortgage market.

Aside from this argument, there is a second, supplementary one that explains why
Fannie Mae and Freddie Mac moved away from the conventional mortgage market and
into the subprime mortgage market. According to this argument, Congress made
increasing demands on the two housing GSEs to make homeownership more affordable
for Americans that could not qualify for a conforming mortgage. These increasing
demands “shoved” Fannie Mae and Freddie Mac into the subprime market because they
were required to assist borrowers that could not qualify for prime mortgage loans.

There is certainly some merit to this argument and, for the sake of brevity, I will
only provide a rough sketch of Fannie Mae and Freddie Mac’s affordable housing goals
in the mid-1990’s and into the 2000’s to lend credence to it. On July 16, 1991,
Congressman Henry Gonzales introduced H.R. 2900, the “Government-Sponsored
Housing Enterprises Financial Safety and Soundness Act of 1991.” One of the key parts
of the bill outlined a list of affordable housing goals for the two housing GSEs. In a
September 17, 1991 report, the House of Representatives’ Committee on Banking,
Finance, and Urban Affairs clearly explained the rationale behind the goals. The
Committee wrote, “[These affordable housing] goals will… facilitate the development in
both enterprises of an ongoing business effort that will be fully integrated in their
products and cultures to service the mortgage finance needs of a growing nonprofit,
public, and for-profit sector that is developing and preserving affordable housing for very
The language of the bill is informative. As government-sponsored enterprises, the bill states, Fannie Mae and Freddie Mac have “an affirmative obligation to promote affordable housing for low- and moderate-income families.”

The next year, on May 15, 1992, Senator Donald Riegle introduced S. 2733, the “Federal Housing Enterprises Regulatory Reform Act of 1992.” S. 2733 also contained provisions for establishing affordable housing goals for Fannie Mae and Freddie Mac. Neither H.R. 2900 or S. 2733, however, became a law.

On June 6, 1992, Congressman Gonzalez introduced H.R. 5334, the “House Community Development Act of 1992,” which became a law on October 28, 1992. Title XIII, Part 2, Subtitle B is the section of the bill that imposed “three broad affordable housing goals” on Fannie Mae and Freddie Mac. Title XIII was a compromise between the affordable housing provisions contained in H.R. 2900 and S. 2733. The first of the three affordable goals was the low- and moderate-income goal, “for borrowers or renters earning no more than the area median income where they reside.”

The Department of Housing and Urban Development (HUD) did not provide a specific target percentage for meeting this goal until 1996, when they decided that at least 40% of Fannie Mae and Freddie Mac’s mortgage purchases had to be for low- and moderate-income persons.

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2957 Ibid.

The second affordable housing goal was a geographically targeted goal, one that involved borrowers or renters residing in underserved areas or higher minority areas. HUD asserted that underserved areas are characterized by “low-income and high-minority census tracts [that] have high mortgage denial rates and low mortgage origination rates.” HUD set the initial “underserved areas goal” in 1996 and it required that 21% of Fannie Mae and Freddie Mac’s mortgage purchases be for borrowers living in an area “at or below 90 percent of area median income in metropolitan areas or at or below 95 percent of area median income in nonmetropolitan counties” or in an area with “a high minority census tract.” HUD increased this percentage to 24% for 1997-2000, 31% for 2001-2004, 37% for 2005, 38% for 2006-2007, and 39% for 2008.

The third and final goal that was established by The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 was the “targeted income-based goal, for special affordable housing, which is housing that is affordable to very low-income families and low-income families living in low-income areas.” This goal targeted borrowers or renters “earning no more than 60 percent of area median income or residing

\[\text{2958 Ibid., 4.} \]
\[\text{2959 Ibid., 6.} \]
\[\text{2960 Ibid., 4.} \]
\[\text{2961 The Department of Housing and Urban Development’s Office of Policy Development and Research, “HUD’s Affordable Lending Goals for Fannie Mae and Freddie Mac,” Issue Brief, No. V (January 2001), 3.} \]
\[\text{2962 The Federal Finance Housing Agency, “The Housing Goals of Fannie Mae and Freddie Mac,” 9. A “high minority census tract” is defined as an area with “30 percent or more minority population in a census tract with a median income no more than 120 percent of area median income.”} \]
\[\text{2963 Ibid., 10.} \]
\[\text{2964 The Department of Housing and Urban Development’s Office of Policy Development and Research, “HUD’s Affordable Lending Goals for Fannie Mae and Freddie Mac,” 3.} \]
in low-income census tracts and earning no more than 80 percent of area median income.”  

Similar to the other two affordable housing goals, the HUD released the first targeted income-based or “special affordable” goal in 1996, stipulating that 12% of Fannie Mae and Freddie Mac’s mortgage purchases meet the criteria for special affordable housing. HUD increased this percentage to 14% for 1997-2000, 20% for 2001-2004, 22% in 2005, 23% in 2006, 25% in 2007, and 27% in 2008.

It is far beyond the scope of this paper to analyze whether HUD’s affordable housing goals were reasonable. I mention these regulations, however, to avoid the fairly popular misconception that Fannie Mae and Freddie Mac entered the subprime mortgage market with subterfuge and solely out of a desire to perpetuate profitability. As far back as 2000, Patrick Barta, writing for The Wall Street Journal, reported, “HUD has long charged that Fannie and Freddie don’t do enough to help low-income and minority families purchase homes.” In 1994, Fannie Mae pledged to finance $1 trillion in loans for disadvantaged families within seven years, and in 2000 the housing GSE promised to underwrite $2 trillion “of new mortgages during the next ten years for minorities, young families, woman-headed families, immigrants, and others whose homeownership rates lag behind the general population.” Barta notes that the announcement in 2000 was made “in the wake of a continuing dispute between the Department of Housing and Urban Development and Fannie Mae over whether the company's lending policies discriminate against minorities.”

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2966 Ibid., 7.
2967 Ibid., 8.
2970 Ibid.
One needs to remember that there were very real political pressures being applied to Fannie Mae and Freddie Mac to purchase subprime mortgages from lenders in the mid-1990’s and early 2000’s. Prior to the outbreak of the subprime mortgage crisis, Congress failed to diffuse the systemic risks posed by Fannie Mae and Freddie Mac’s gigantic retained portfolios and simultaneously required the two housing GSEs to take on greater risks in the interest of assisting underserved borrowers. Of particular importance is the fact that, with respect to Fannie Mae and Freddie Mac’s respective chartered government missions, Congress tended to privilege the “affordable mortgage credit” objective over the “stable secondary mortgage market” goal. Any discussion of Fannie Mae and Freddie Mac’s role in the subprime mortgage crisis that does not include their complex relationship with Congress is, in my opinion, deficient.

6.11. Fannie Mae and Freddie Mac’s Immersion Into the Subprime Mortgage Market

Before embarking on an investigation of Fannie Mae and Freddie Mac’s involvement in the subprime mortgage market, it is important to articulate what constitutes a “subprime” mortgage loan. As Edward Pinto notes, “One of the reasons for confusion about the number of subprime and Alt-A mortgages outstanding at any time in the U.S. is that many of the participants and reporting agencies used different definitions of the same terms.” Peter Wallison and Charles Calomiris argue that Fannie Mae and Freddie Mac used their own impoverished definitions of subprime mortgages to

“purposely and significantly understate their commitment” to them.\textsuperscript{2972} Offering a definition of this crucial term will help bring about a more effective examination of the extent to which the two housing GSEs’ purchased these risky products. Furthermore, a definition of an “Alt-A mortgage” needs to be presented. An analysis that focuses entirely on the total amount of subprime loans that Fannie Mae and Freddie Mac purchased, while excluding their Alt-A loan purchases, only captures part of the risks that the two housing GSEs undertook in the mid-1990’s well through the first decade of the 2000’s.

To bring clarity to this discussion, Edward Pinto suggests that there are actually two “varieties” of subprime mortgage loans: self-denominated subprime loans and subprime loans by characteristic. Self-denominated subprime loans are those that are classified as “subprime” by the originator of the loans, which is usually either “a lender specializing in the subprime business” or a subprime division within a large lender.\textsuperscript{2973} This is a terribly important distinction because Fannie Mae elected to label its purchased loans as “subprime” only if the loans were self-denominated as such. To phrase this point differently, the only criterion that Fannie Mae used to determine if their purchased loans were “subprime” was who the originator of those loans happened to be. Pinto claims that this classification system “had the effect of reducing [Fannie Mae’s] subprime loan count to a very small number.”\textsuperscript{2974} A large lender that does not have a subprime division could have obviously originated mortgage loans of subprime quality.

The second variety of subprime loans is what Pinto calls “subprime loans by characteristic.” In this case, a loan is considered to be subprime on the basis of “objective

\textsuperscript{2972} Peter J. Wallison and Charles W. Calomiris, “The Last Trillion Dollar Commitment: The Destruction of Fannie Mae and Freddie Mac.”
\textsuperscript{2973} Edward Pinto, “Memorandum: Sizing Total Federal Government and Federal Agency Contributions to Subprime and Alt-A Loans in U.S. First Mortgage Market as of 6.30.08,” 2.
\textsuperscript{2974} Ibid.
risk characteristics,” most commonly a borrower FICO score of 660 or below.\textsuperscript{2975} Pinto maintains that using a borrower FICO score below 660 “as the demarcation between prime and subprime loans” dates back to 1995.\textsuperscript{2976} There appears to be some justification for using a 660 FICO score as a line of demarcation between subprime and prime loans. Borrowers with a FICO score between 620-659 have proven to be 6.4 times more likely to default on their mortgages than borrowers with a FICO score of 660 and above.\textsuperscript{2977} As for those borrowers with a FICO score below 620, they are 9 times more likely to default on their mortgages than borrowers with a FICO score of 660 and above.\textsuperscript{2978}

In addition to subprime loans, Fannie Mae and Freddie Mac also purchased Alt-A mortgage loans. Alt-A mortgages received their name from being “alternative to agency,” which means that they “did not meet the traditional underwriting guidelines” of Fannie Mae and Freddie Mac in one or more ways.\textsuperscript{2979} In many cases, Alt-A mortgage loans have either “low or no [borrower] documentation requirements,”\textsuperscript{2980} earning the derisive nickname of “liar loans.” Pinto maintains that the two housing GSEs became “active Alt-A purchasers” in 2002, leading to a tremendous expansion of the Alt-A market through 2008.\textsuperscript{2981}

\textsuperscript{2975} Ibid.
\textsuperscript{2976} Ibid.
\textsuperscript{2978} Ibid.
\textsuperscript{2979} Ibid., “Memorandum: Sizing Total Federal Government and Federal Agency Contributions to Subprime and Alt-A Loans in U.S. First Mortgage Market as of 6.30.08,” 3.
\textsuperscript{2981} Ibid., 49.
Similar to his distinction within subprime loans, Pinto argues that there are two varieties of Alt-A loans: self-denominated and Alt-A loans by characteristic.\(^{2982}\) A self-denominated Alt-A loan receives that title if the lender or originator delivering the loan to Fannie Mae or Freddie Mac initially classified it as such, or if the loan was placed in an Alt-A private mortgage-backed security.\(^{2983}\) An Alt-A loan by characteristic is one that was not “initially classified as Alt-A” by the lender or originator and features non-traditional adjustable rate mortgage terms, like a “teaser” rate or “no or negative amortization.”\(^{2984}\) If an adjustable rate mortgage has a teaser rate, the mortgage will have a low introductory interest rate that will reset and increase at some point in the future. A negative amortization mortgage loan is one that, for an initial, specified period of time, requires the borrower to make a payment that is smaller than the interest due. The unpaid interest is then added to the remaining loan balance, increasing the total amount that the borrower owes. A mortgage loan with no amortization, or an interest-only loan, requires the borrower to only pay the interest due for a predetermined period of time. Alternately, an Alt-A loan by characteristic could also be one that has a “high original LTV,” including a loan-to-value (LTV) ratio of 97% or even 100%.\(^{2985}\) LTV ratio refers to the size of the mortgage loan compared to the value of the property that the loan is securing. If a borrower takes out a $194,000 mortgage loan to purchase a house that has been appraised for $200,000, that loan would have a LTV ratio of 97%. Mortgage loans with high LTV ratios are accompanied by lower borrower downpayments.

\(^{2983}\) Ibid.
\(^{2984}\) Ibid.
\(^{2985}\) Ibid.
Pinto provided a great service by parsing out the characteristics of subprime and Alt-A mortgage loans, for it is apparent that both types of loans are less-than-prime and, consequently, riskier than conventional loans. Media fixation on the term “subprime” could have contributed to a distorted public perception of the risks that accompanied Fannie Mae and Freddie Mac’s Alt-A loan purchases. Pinto accuses the two housing GSEs of failing to “classify many of their loans with Alt-A characteristics as Alt-A loans” as early as the beginning part of the 1990’s. Thus, an investor or any other individual who was knowledgeable of the risks associated with Alt-A mortgage loans would have had a difficult time discovering the extent to which Fannie Mae and Freddie Mac were involved in the Alt-A mortgage market.

Having offered definitions of subprime and Alt-A mortgage loans, it is now necessary to examine the extent of the two housing GSEs’ exposure to these loans. According to Pinto, as of June 30, 2008, Fannie Mae held or guaranteed 7,026,000 subprime and Alt-A mortgage loans, totaling approximately $1.077 trillion. It is striking that the vast majority of those loans were not self-denominated subprime loans, which were the only ones that Fannie Mae classified as “subprime.” Of those 7,026,000 loans, 6,616,000 of them (a little over 94%) were either subprime by characteristic, self-denominated Alt-A, or Alt-A by characteristic. Pinto estimates that those loans have a value of roughly $1.011 trillion. As for Freddie Mac, Pinto reports that, as of June 30,
2008, the housing GSE held or guaranteed 4,913,000 subprime and Alt-A mortgage loans worth $758 billion.\textsuperscript{2991} Of those loans, 4,155,000 of them (about 84.5\%) were either subprime by characteristic, self-denominated Alt-A, or Alt-A by characteristic, possessing a total value of $635 billion.\textsuperscript{2992} Putting these figures in perspective, Pinto claims that Fannie Mae and Freddie Mac held or guaranteed nearly one-third of all subprime mortgage loans and approximately two-thirds of all Alt-A mortgage loans at the end of 2008.\textsuperscript{2993} Moreover, the 11,939,000 subprime loans that they held or guaranteed at the end of 2008 were approximately 21.8\% of the 55 million mortgages outstanding in the United States at the time.\textsuperscript{2994}

In a later report, Pinto asserted that “the long term misrepresentation by the GSEs as to the risks they were acquiring was finally admitted by Fannie on November 10, 2008 when it disclosed its 10-Q.”\textsuperscript{2995} Fannie Mae’s confession is worth quoting in full:

We have classified mortgage loans as Alt-A if the lender that delivered the mortgage loans to us had classified the loans as Alt-A based on documentation or other features. We have classified mortgage loans as subprime if the mortgage loan was originated by a lender specializing in the subprime business or by subprime divisions of large lenders. We apply these classification criteria in order to determine our Alt-A and subprime loan exposures; however, we have other loans with some features that are similar to Alt-A and subprime loans that we have not classified as Alt-A or subprime because they do not meet our classification criteria.\textsuperscript{2996}

The “long term misrepresentation by the GSEs” to which Pinto is referring comes in the form of Fannie Mae holding or guaranteeing over $1 trillion worth of subprime and Alt-A

\textsuperscript{2991} Ibid., 8.
\textsuperscript{2992} Ibid.
\textsuperscript{2996} Ibid. Italics mine.
mortgages without labeling them as such because the lenders supplying the loans did not specialize in the “subprime business” or were not large lenders with “subprime divisions.”

Given the extent of their commitment to riskier loans in the late 1990’s and early 2000’s, I agree with Congressman Mark Souder’s insight that Fannie Mae and Freddie Mac were “enabler’s” agencies.2997 Their aggressive entrance into the subprime mortgage market had an incredible demand-enhancing effect on subprime mortgages, encouraging lenders in the primary market to incautiously originate a higher proportion of these mortgages to match the increased demand for them. As Wallison and Calomiris explain, “[Fannie Mae and Freddie Mac’s] buying patterns and interests were followed closely in the markets. If Fannie and Freddie wanted subprime or Alt-A loans, the markets would produce them.”2998 As government-sponsored enterprises, their demand for subprime (and Alt-A) mortgages signaled to the lenders in the primary market to accelerate their originations of these loans. Fannie Mae and Freddie Mac’s decision to enter into the subprime mortgage market was, therefore, an indispensable condition for the wild expansion of that market and the subsequent saturation of the global financial economy with subprime mortgage-backed securities.2999

2997 United States House of Representatives Committee on Oversight and Government Reform, “The Role of Fannie Mae and Freddie Mac in the Financial Crisis,” 87.
2999 In a recent book written by Simon Johnson and James Kwak, the two authors write, “The financial crisis was not primarily due to Fannie and Freddie.” Johnson and Kwak, 13 Bankers: The Wall Street Takeover and the Next Financial Meltdown (New York: Pantheon, 2010), 144. The two authors argue that although Fannie Mae and Freddie Mac created demand for conventional mortgages, “regulatory constraints prevented them from plunging too far into subprime lending.” Ibid., 145. This assertion obviously hinges on one’s definition of “subprime,” and it appears that their definition includes only self-denominated subprime loans, as defined by Edward Pinto. I find Pinto’s definitions of subprime and Alt-A mortgages to be more comprehensive and useful for discussing the role that the two housing GSEs played in the subprime mortgage crisis.
6.12. Conclusion

In 1933, Franklin Roosevelt stated, “The broad interests of the nation require that special safeguards should be thrown around homeownership as a guarantee of social and economic stability.”\footnote{3000} Two of the special safeguards that surrounded homeownership in the United States were Fannie Mae and Freddie Mac. Endowed with government privileges, the two housing GSEs were enlisted to serve as mortgage alchemists: transforming the luxurious good of homeownership into an affordable good, converting illiquid mortgage loans into liquid securities, and creating a stable secondary market for a product that is plagued with credit, prepayment, and other latent risks. As privately owned companies, Fannie Mae and Freddie Mac had the additional challenge of performing those tasks while maximizing shareholder returns. This tension, between a congressionally-mandated mission to the public and a fiduciary duty to shareholders, was mostly reconciled when housing prices were rising and the conventional mortgage marketing was growing. However much success Fannie Mae and Freddie Mac had in meeting both of those goals, they were nevertheless embroiled in scandals and legal issues throughout the early 2000’s and placed in conservatorship a year before Freddie Mac celebrated its twentieth year as a publicly traded company.

Congress, under the sway of group bias, was unable to enact significant legislation in time to mitigate the risks that the two housing GSEs were posing to the economy, most notably by the size of their retained portfolios. Protected by their respective missions, a near-ubiquitous public endorsement of the good of homeownership that was stoked by effective advertisements, campaign contributions, and other factors

listed above, Fannie Mae and Freddie Mac were able to become two of the largest purchasers of subprime mortgages, while remaining predominantly immune from any serious congressional dissent.

In conclusion, one could view Fannie Mae and Freddie Mac’s hybrid structure, part instrumentality, part shareholder owned, as a failed experiment. Unable to protract their extraordinary growth and profitability in the face of quarterly earnings pressure nor satisfy the demands of Congress by remaining exclusively in the prime, conventional mortgage market, both of the housing GSEs ventured into the subprime mortgage market in search of greater profits and a larger pool of low-income borrowers. Both Fannie Mae and Freddie Mac were already involved in the subprime mortgage market by the late 1990’s and this venture was indeed encouraged by Congress, who imposed three broad affordable housing goals on the housing GSEs. These goals became effective in 1996 and progressively more demanding during each successive year up until 2008. The implied federal government guarantee of their debt obligations enabled Fannie Mae and Freddie Mac to attract investor capital for their subprime mortgage purchases, intensifying a market demand for them.

Ultimately, then, Fannie Mae and Freddie Mac were responsible for pulling off what proved to be an intricate and unsustainable balancing act. With home prices rising, the mortgage market expanding, mostly unwavering political support, and a reliable incoming flow of investor capital, the two housing GSEs were temporarily able to provide spectacular returns to their shareholders, bring liquidity to the secondary mortgage market, and arguably make mortgage credit more affordable for borrowers traditionally deemed to be under-qualified. Purchasing and holding subprime (and Alt-A)
mortgages in their retained portfolios conferred upon Fannie Mae and Freddie Mac a triple-benefit. First, they could plausibly claim that they were working towards Congress’ affordable housing goals as they purchased subprime mortgages, thus making mortgage credit more affordable. Second, since it appeared that the two housing GSEs were outgrowing the conventional mortgage market, delving into the subprime mortgage market provided an opportunity for further growth and profitability, which would assist with their efforts to maximize returns to shareholders. Finally, with the demands of Congress and their shareholders appeased, Fannie Mae and Freddie Mac were in a prime position to continue serving as seemingly attractive investment opportunities to investors. Both of Fannie Mae and Freddie Mac’s lines of business could thrive and the steady flow of investor capital contributed to creating a liquid secondary mortgage market.

What has become apparent, however, is that Fannie Mae and Freddie Mac were unable to provide all of these services while simultaneously ensuring that the secondary mortgage market would remain stable. The losses for both firms have continued through the end of 2011: Fannie Mae lost $16.855 billion during the year, while Freddie Mac lost $5.266 billion.\footnote{N. Eric Weiss, “Fannie Mae’s and Freddie Mac’s Financial Problems,” CRS Report for Congress (April 2, 2012), available at http://www.fas.org/sgp/crs/misc/RL34661.pdf, 2.} Since year-end 2007 to the end of 2011, Fannie Mae has posted $163.595 billion in losses. Over that same period of time, Freddie Mac suffered $94.057 billion in losses.\footnote{Ibid.} The Congressional Budget Office estimates that the two housing GSEs may cost taxpayers nearly $400 billion over the next decade.\footnote{Ibid., “Costs Surging for Freddie Mac and Fannie Mae,” The New York Times (June 20, 2010).} As Zachary Goldfarb noted, writing for \textit{The Washington Post}, “[I]t is becoming increasingly clear
that the rescue of Fannie and Freddie will be the most expensive part of the government’s response to the financial crisis.\textsuperscript{3004}

\textsuperscript{3004} Zachary A. Goldfarb, “Mortgage Bailout’s Ballooning Price,” \textit{The Washington Post} (October 22, 2010).
“Yet as things are, in the aftermath of economic and political upheavals, amidst the fears of worse evils to come, the thesis of progress needs to be affirmed again.”

Bernard Lonergan, *Insight*, p. 710

**Conclusion**

The product of a staggering accumulation of biased decisions over time, the subprime mortgage crisis was an avoidable outcome. With house prices on the rise and reliable profits to be earned, subprime mortgage market participants were tempted, with the aid of the general bias of common sense, to leap to the irresistible conclusion that house prices would *interminably* rise and profits could, therefore, be *inexhaustibly* mined from this historically risky segment of the market. This biased perception of the profit potential of the subprime mortgage market was the central and defective cog around which certain flawed institutional relationships were built.

Subprime lenders originated and extracted fees from mortgage loans that were inappropriate for borrowers because arrangers were more interested in the volume of subprime loans than in their quality. Arrangers clamored for high volumes of subprime loans with unknown or questionable credit risk because the loans could be securitized into MBSs and CDOs. Once securitized, these financial products could be submitted to one or more of the three largest NRSRO’s for a credit rating evaluation. Since the NRSRO’s were not compensated for the accuracy of their credit ratings, but for the sheer amount of ratings that they could produce, they had an incentive to give their paying customers, the arrangers, the type of rating that they wanted most: those of the triple-A variety. Fannie Mae and Freddie Mac, meanwhile, began to outgrow the conventional
mortgage market around the turn of the century. The two housing GSEs discovered that the subprime mortgage market conveniently had the capacity to satisfy both of their masters: Congress and their shareholders.

In the short term, subprime lenders, which were enshrouded in immense financial holding companies, benefited from a fragmented federal regulatory apparatus that forced each regulator into its own silo. Effective oversight of these lenders was also undermined by a phenomenon known as “charter shopping,” which incited the OCC and OTS to give a light touch to their regulatory efforts in exchange for lender-paid fee revenue and a heightened perception of relevance. Among the most devastating of these deregulatory decisions was the one that enabled the OCC and OTS to preempt state consumer protection laws. The Federal Reserve, for its part, refused to determine what should constitute unfair and deceptive mortgage practices until it was too late and, in the process, abstained from regulating non-depository mortgage lending affiliates, like Countrywide Home Loans.

The five largest arrangers were the short-term beneficiaries of the SEC’s woefully misguided “Consolidated Supervised Entity Program,” which permitted them to set their own leverage ceilings, removing the more prudent leverage ratio of 15 to 1. The program also transformed the nature of the SEC’s oversight of the five arrangers. Now only under the weak pull of submitting to voluntary supervision, the arrangers were in a position to take wildly excessive and ultimately destructive risks. By the end of 2008, Bear Stearns and Merrill Lynch were acquired by other firms, Lehman Brothers filed for bankruptcy protection, and Goldman Sachs and Morgan Stanley were compelled to become bank holding companies.
In the wake of Freddie Mac and Fannie Mae’s accounting scandals in 2003 and 2004, respectively, Congress was in a prime position to create timely regulations that could have made the two housing GSEs safer and sounder institutions before the subprime mortgage crisis began to unfold. Ultimately, however, Congress failed to enact any such legislation, which likely proved to be politically advantageous to individual members of the House of Representatives and Senate, but incredibly costly to American taxpayers. In four years, from the end of 2007 to the end of 2011, Fannie Mae and Freddie Mac combined to post a total of over $257 billion in losses.

The Gramm-Leach-Bliley Act of 1999 and the Commodities Futures Modernization Act of 2000 combined to severely impair any effective regulatory oversight of the budding CDS market. Unmoored from virtually all regulatory requirements and seduced by what it thought was a steady incoming flow of virtually risk-free profits, a unit within AIG elected to sell a reckless amount of credit protection on subprime-related securities without setting aside an adequate reserve of money to shield it from potential losses. As the subprime mortgage market cratered, a nearly 90 year old company – with over $1 trillion worth of assets – ran out of cash in September of 2008. AIG was kept afloat by receiving $182.4 billion in aid from the Federal Reserve and the Treasury Department.

In the final analysis, institutions and the individuals working within them have the potential to carry out or undermine values. One does not have to travel very far up Lonergan’s scale of values to discover that social values, those values that, when chosen, contribute to the functioning of the good of order, were profoundly neglected as the different parties involved in the subprime mortgage crisis operated and cooperated in
biased ways. As Lonergan notes, decisions infected with group bias start off as neglected possibilities, as lost opportunities for freely chosen intelligent, reasonable, and responsible courses of action to contribute to human progress. Over time, however, these neglected possibilities accumulate and congeal into a grotesquely distorted reality.\(^{3005}\)

This development was obscured, at least to a certain extent, by the cultural value of homeownership in America. Viewed through the lens of the American Dream, owning a home was not equated with the mere particular good of shelter. Homeownership, as a sign of success, a pillar of stability, and an embodiment of freedom and independence became, as Michael Hudson aptly observed, “the great popular arena in which to seek speculative gains.”\(^{3006}\) Since owning a home in America carries with it certain visceral cultural values, the large variety of institutions responsible for ultimately providing instances of this treasured particular good were able to use its cultural significance as a platform for relegating personal values beneath the subjectively satisfying and dissatisfying. In particular, these institutions masked a neglect of social values by way of generating the particular good of short-term profits. In other words, the various parties involved in the subprime mortgage crisis could use the cultural currency of the value of homeownership in America to disguise or at least justify personal decisions that, eventually, not only failed to respect that cultural value,\(^{3007}\) but also bypassed considerations that would have embraced social values. These latter, inadequately entertained considerations would have raised further pertinent questions for evaluation.

\(^{3005}\) *Insight*, 250.


\(^{3007}\) For example, from September of 2008 to June of 2012, there have been 3.7 million foreclosures, according to the data analysis firm, CoreLogic. Please see: “Completed U.S. Foreclosures Hold Steady in June,” *Reuters* (July 31, 2012), available at http://in.reuters.com/article/2012/07/31/usa-housing-corelogic-idINL2E8IV1PK20120731.
and deliberation, beyond those involving profitability, such as *whether one should* assume certain roles and *how one should* go about performing certain tasks.

The combination of group bias with general bias triggered the subprime mortgage crisis, an instance of Lonergan’s notion of the longer cycle of decline, which is a process that results in the cumulative deterioration of the social situation. Mass foreclosures, rampant unemployment, widespread wealth destruction, and a growing popular resentment of what has come to be labeled “the 1%” are all manifestations of this distorted social situation. Lonergan vividly describes this deterioration in *Insight*, a depiction that hauntingly applies to the aftermath of the subprime mortgage crisis:

> The objective social situation possesses the intelligibility put into it by those that brought it about. But what is put in, less and less is some part of a coherent whole that will ask for its completion, and more and more it is some arbitrary fragment that can be rounded off only by giving up the attempt to complete the other arbitrary fragments that have preceded or will follow it. In this fashion social functions and enterprises begin to conflict; some atrophy and others grow like tumors; the objective situation becomes penetrated with anomalies; it loses its power to suggest new ideas and, once they are implemented, to respond with still further and better suggestions. The dynamic of progress is replaced by sluggishness and then by stagnation.

Yet, even as bleak as things may potentially seem, nothing is inevitable, and the dynamism of human intelligence has the extraordinary capacity to creatively and sagely address the daunting challenges posed by what has now become a formidable social surd. This surd “resides least of all in outer things and most of all in the minds and wills of men.”

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3008 *Insight*, 254.
3009 Ibid.
3010 Ibid., 258.
3011 Ibid., 712.
individual’s “personal authenticity, honesty, and genuineness.” Or, as Lonergan puts it, “The only solution lies in ‘the good man’.”

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Glossary of Abbreviated Terms

**AIGFP:** American International Group Financial Products. A part of AIG’s Financial Services unit that included AIG Financial Products Corporation, AIG Trading Group, and all of their respective subsidiaries.

**ARM:** Adjustable-Rate Mortgage. A type of mortgage whose interest rate adjusts to a particular index over some specified period of time.

**CDO:** Collateralized Debt Obligation. The generic term for a type of security that can be backed by any type or combination of types of debt.\(^{3013}\) For example, CDO’s can be backed by subprime MBSs.

**CDS:** Credit-Default Swap. A type of contract whose value and structure is derived from certain referenced underlyings, such as debt obligations. A CDS contract links two parties together, a protection buyer and a protection seller. The protection buyer, for a periodic fee, offloads the credit risk that the referenced underlyings possess onto the protection seller.\(^{3014}\)

**FDIC:** Federal Deposit Insurance Corporation.

**GAO:** The United States Government Accountability Office.

**GSE:** Government-Sponsored Enterprise. The two housing GSEs are Fannie Mae and Freddie Mac.

**HUD:** The Department of Housing and Urban Development. One of the two federal regulators of Fannie Mae and Freddie Mac leading up to the subprime mortgage crisis. HUD’s responsibility was to ensure that the two housing GSEs were fulfilling their chartered missions’ requirements.

**Leverage:** When an institution’s assets exceed its equity base, that institution is leveraged. Arrangers engaged in leverage “by borrowing to acquire more assets, with the aim of increasing their return on equity.”\(^{3015}\)

**MBS:** Mortgage-Backed Security. A security that is backed by collateral that comes in the form of mortgages on borrowers’ homes.\(^{3016}\)

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**NINA loan:** No Income / No Asset documentation mortgage loan.

**NRSRO:** Nationally Recognized Statistical Rating Organization. The three largest NRSRO’s are Moody’s, Standard and Poor’s, and Fitch.

**OCC:** The Office of the Comptroller of the Currency. The regulator of federally chartered national banks and their non-depository mortgage lending subsidiaries.

**OFHEO:** The Office of Federal Housing Enterprise Oversight. A federal regulator that was responsible for Fannie Mae and Freddie Mac’s safety and soundness oversight.

**OTS:** The Office of Thrift Supervision. The regulator of federally chartered thrifts and their non-depository mortgage lending subsidiaries. On July 21, 2011, all of the OTS’ functions were transferred to the OCC.\(^{3017}\)

**Repo:** An abbreviation of the term “repurchase agreement.” A repo is a transaction in which “a borrower sells a security to a lender with an option to repurchase it at a price that provides the lender with a return appropriate for a secured loan.”\(^{3018}\) This was a key funding source for many arrangers leading up to the subprime mortgage crisis.

**SEC:** Securities and Exchange Commission.

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\(^{3016}\) Patricia A. McCoy and Elizabeth Renuart, “The Legal Infrastructure of Subprime and Nontraditional Home Mortgages,” 28


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