Developments in Banking and Financial Law: 2008-2009

The Credit Crisis of 2008

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Staff Introduction

The year 2008 brought sweeping changes to the U.S. financial sector. Late summer and early autumn saw the fall of venerable investment banks, the merger of consumer banking goliaths, and the intervention of the federal government and the Federal Reserve Bank. At the root of this turmoil was a fundamental problem for entities attempting to do business on a day-to-day basis: Credit, at the consumer and wholesale level, became scarce as lenders saw faults in their own balance sheets.

This series of articles tracks the credit crisis problem from its root causes to its short-term and long-term effects. These articles cover events and developments through late October, 2008. Of course, significant events have occurred in the interim, but this section gives the reader a broad, comprehensive overview of the issues. From it, the reader can analyze more timely events and start a discussion as to what truly happened in the 2008, when the U.S. (and world) economy dealt with its most significant difficulties in the previous 25 years.

I. The Roots of the Credit Crunch of 2008

In 2008, economic crises engulfed the globe. Stock markets fell as inflation rose. Consumer spending declined while unemployment rates climbed. Millions of homeowners faced foreclosure. Entire nations, such as Iceland and Hungary, teetered on the verge of bankruptcy. Frightened investors and savers lined up for hours to withdraw funds from their failing banks. Yet while these dramatic events captivated the majority of the public's attention, a quieter but more insidious threat lingered: the ongoing credit crisis.

A. A Credit Crisis and Its Typical Causes

A credit crisis, alternatively described as a credit crunch, occurs when available credit suddenly decreases or when the cost of obtaining credit suddenly increases. As credit becomes more difficult and more costly to obtain, lenders turn away borrowers. The halt in lending triggers a series of catastrophic consequences. Spending and growth grind to a halt.[1] Mortgage lenders become more discriminating and many people cannot finance a new home. Home equity lenders cancel or reduce existing lines of credit, leaving homeowners unable to finance special projects or purchases they had planned. These unrealized projects and purchases leave a variety of businesses without customers. Credit card companies offer fewer new cards and decrease their current customers' limits.[2] Those who are able to secure new loans or lines of credit can expect to pay higher rates.[3] In addition, panicked investors rush to buy credit-default swaps[4] to insure against potential bankruptcy.[5] Larger

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[1] *See generally* Louis Uchitelle, *Pain Spreads as Credit Vise Grows Tighter*, N.Y. TIMES, Sept. 19, 2008, at A1, *available at* http://www.nytimes.com/2008/09/19/business/economy/19econ.html?ei=5070 (discussing the impact of the credit squeeze upon businesses and consumers).

[2] *Id.*

[3] Ismat Sarah Mangla, *The Credit Crunch Hits Your Wallet*, MONEY, Oct. 1, 2008, at 43 ("In July [2008] the Federal Reserve reported that sixty-five percent of banks had tightened lending standards on credit cards, up from thirty percent in April [2008] . . . .").

[4] "Credit default swaps are insurance-like contracts that promise to cover losses on certain securities in the event of a default. They typically apply to municipal bonds, corporate debt and mortgage securities and are sold by banks, hedge funds and others. The buyer of the credit default insurance pays premiums over a period of time in return for peace of mind, knowing

financial institutions hoard their capital to protect themselves and may refuse to lend even to other banks.

These types of freezes in credit emanate from a number of causes, both real and imagined. Waning confidence in a market can squeeze credit further, even if the perception of risk is far greater than the actual threat. Depositors may withdraw their money from institutions believed to be at risk of insolvency. These institutions in turn need more capital, but may also find themselves cut off from their lenders.[6] Most credit crises, including the current one, are at least in part a crisis of faith:

> The word "credit" derives from the Latin *crederi*, which means to believe. People stopped believing both in the borrowers and in the new credit instruments. Too many of the investors had no idea of the risks they were exposed to . . . . Cash is withdrawn, credit lines are pulled, counterparty risks are unwound, and the result is a freeze up of credit and a downward spiral of asset values . . . ."[7]

Investors' shaken faith alone, however, typically does not cause a large credit crisis. Credit tightens in reaction to a variety of

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that losses will be covered if a default happens." Janet Morrissey, *Credit Default Swaps: The Next Crisis?*, TIME, Mar. 17, 2008, *available at* http://www.time.com/time/business/article/0,8599,1723152,00.html.

[5] *See, e.g.*, Joe Nocera, *As Credit Crisis Spiraled, Alarm Led to Action*, N.Y. TIMES, Oct. 2, 2008, at A1, *available at* http://www.nytimes.com/2008/10/02/business/02crisis.html (contending that credit-default swaps were purchased at thirty times their normal price during the month of September 2008).

[6] *See* Allan Sloan & Roddy Boyd, *The Lehman Lesson*, FORTUNE, Sept. 29, 2008, at 84, *available at* http://money.cnn.com/2008/09/12/news/companies/sloan_lehman.fortune/ (claiming that Lehman Brothers, which ultimately failed as its leverage increased, "looked as if it would be able to survive more or less intact after the Federal Reserve Board announced in March [2008] that it would make huge loans available to eligible investment banks . . . [b]ut Lehman never fully regained the market's confidence, Fed and Treasury support notwithstanding.").

[7] Mortimer B. Zuckerman, *Wall Street's Day of Reckoning*, U.S. NEWS & WORLD REP., Sept. 29, 2008, *available at* http://www.usnews.com/articles/opinion/mzuckerman/2008/09/19/wall-streets-day-of-reckoning.htm.

actual threats to the economy. Changed monetary conditions may create a freeze in credit markets. For example, if the central bank raises interest rates[8] or reserve requirements, banks likely loan less money.[9] Credit may also tighten if the government imposes controls on credit. Moreover, after a period of sustained careless lending, a credit market will contract. The current credit crunch arose from a perfect storm of factors combined to produce one of the tightest credit squeezes in the history of the United States. In the fall of 2008, several major financial institutions, which were unable to raise enough capital, went bankrupt, were forcibly sold or merged, or were rescued entirely by the federal government. Faced with the largest decline in the stock market in decades and a near collapse of the entire economic system, the federal government responded with unprecedented bailouts totaling billions, and perhaps trillions, of dollars. The current credit crunch sparked what many are already calling an international recession, ne that will continue until credit becomes more easily available.

B. Origins of the Current Credit Crisis

The most apparent and most discussed cause of the current credit crunch is the subprime mortgage crisis of 2007. For nearly a decade before 2007, low interest rates made buying a home easier than ever before. Some banks extended credit to applicants without documentation of their ability to repay their loans.[10] Lenders offered people who had no proof of income or assets low "teaser" rates.[11] In many cases, lenders also waived down payment requirements. Despite the risk inherent in these loans, lenders were able to maintain

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[8] *See generally* Keith Bradsher, David Jolly, & Edmund L. Andrews, *Central Banks Coordinate Cut in Rates*, N.Y. TIMES, Oct. 9, 2008, *available at* http://www.nytimes.com/2008/10/09/business/09fed.html?partner=rssnyt &emc=rss (acknowledging the Federal Reserve's interest rate cut in October 2008 as an attempt to bolster economic activity).

[9] *See generally Credit and Blame*, ECONOMIST, Sept. 11, 2008, *available at* http://www.economist.com/finance/displaystory.cfm?story_id=12209655 (discussing the role of central banks' decisions to change interest rates).

[10] *See generally* Mortimer B. Zuckerman, *Credit Crunch*, U.S. NEWS & WORLD REP., Aug. 5, 2007, *available at* http://www.usnews.com/usnews/ opinion/articles/070805/13edit.htm (discussing some of the most risky of the subprime loan practices, including "ninja" loans extended to people who had no income and no assets).

[11] *Id.*

their relaxed standards as long as housing prices continued to soar. In fact, banks profited more from these risky loans than from traditional mortgages,[12] and financial managers who took on excessive risks were rewarded handsomely despite exposing their companies to more and more debt.[13] But when housing market peaked in 2006 and then began to fall steadily, the value of homes that banks used as collateral when issuing loans steeply declined.[14] The unraveling of America's housing market revealed trillions of dollars worth of over-inflated assets and thousands of mortgages in or nearing default.[15]

The problem of declining collateral was exacerbated by the particular way that banks had packaged and sold mortgages to third parties. Banks broke mortgages into pieces and then collected them in securities that they sold throughout the world. Investors in these complex new debt securities, such as subprime bonds and collateralized debt obligations, often bought without understanding the underlying assets of their purchases.[16] Some Wall Street firms, moreover, did not disclose to them the nature of these assets.[17] Without a long trading history for these new kinds of securities, firms used a mark-to-model, rather than a mark-to-market, means of estimating the value of the underlying assets.[18] In mark-to-market evaluations, firms marked the value of a security to recent sale prices.[19] In contrast, mark-to-model valuations were little more than

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[12] *Id.*

[13] *See* Zuckerman, *Wall Street's Day of Reckoning*, *supra* note 7 (indicating that Fannie Mae and Freddie Mac had sixty-five dollars of debt for every dollar of equity and that they "were dispensing vast rewards to their private management along the way.").

[14] Zuckerman, *Credit Crunch*, *supra* note 10.

[15] *Id*. ("The resulting housing bubble is now bursting, leaving us with prices way out of line with reality and an overhang of unsold property and rising defaults.").

[16] Zuckerman, *Wall Street's Day of Reckoning*, *supra* note 7.

[17] *See* Nelson D. Schwartz, *New Investment Strategies Compound a Fiscal Crisis*, N.Y. TIMES, Sept. 20, 2008, at C8, *available at* http://www.nytimes.com/2008/09/20/business/20crisis.html?partner=rssnyt&emc=rss (claiming that many financial managers did not themselves understand the complexity of the new debt instruments).

[18] Daniel Gross, *The Mark-to-Market Melee*, NEWSWEEK, Apr. 1, 2008, *available at* http://www.newsweek.com/id/130029.

[19] *Id.*

"educated guesses based on algorithms."[20] Firms used mathematical models to estimate the value of their securities for investors.

These models became meaningless as the housing market collapsed. Faced with declining home prices, many firms had to write down the value of underlying assets.[21] Their securities were then downgraded, causing prices to fall as investors no longer trusted the safety of the debt.[22] The declining value of the securities also forced many funds that routinely invested with borrowed money to sell assets to meet margin calls.[23] When the securities decreased in value past a certain point, or margin, fund managers had to find new money to deposit into the account. Typically, this meant selling company assets. Some firms were devastated by the sales.[24] Those that survived hoarded their cash, creating a credit crisis far beyond the world of Wall Street. Without lenders, there were no buyers for the complex securities made from subprime mortgages, which then became illiquid.[25] The collapse of the housing market thus revealed only a portion of the current trouble in finance. The trouble certainly began when declining home prices devalued complex mortgage securities. But for credit markets, the real trouble rested in banks' inability to sell their leveraged loans.[26]

As the current credit crunch wore on, a wave of fear threatened to further freeze markets. Panicked investors withdrawing from a wide variety of financial markets felled institutions long considered too strong to fall.[27] After the failure of venerable institutions like Freddie Mac and Fannie Mae, Bear Stearns, Lehman

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[20] *Id.*

[21] *Id.* (asserting that the decreased value of assets drove banks such as UBS and Citigroup to massive write-downs).

[22] Zuckerman, *Wall Street's Day of Reckoning*, *supra* note 7.

[23] *See* Gross, *supra* note 18.

[24] *See Id.* (identifying Bear Stearns hedge funds that failed because creditors seized their assets and sold them).

[25] *See* Zuckerman, *Wall Street's Day of Reckoning*, *supra* note 7 ("Bank credit has fallen at the fastest rates since the Federal Reserve began collecting weekly figures, . . . [falling] ninety-four percent between the first quarter of 2007 and the first quarter of 2008.").

[26] *See, e.g.*, Zuckerman, *Credit Crunch*, *supra* note 10.

[27] *See* Nocera, *supra* note 5 (observing that Morgan Stanley saw its shares fall twenty-eight percent on September 16, 2008, despite reporting a $1.425 billion profit later that afternoon).

Brothers, and AIG,[28] investors appeared pessimistic. No financial company seemed safe.

The confidence of investors further eroded from the recent decline of money market funds. In September 2008, several money market funds, long viewed as equivalent to bank accounts and without risk, "broke the buck," meaning that they would pay out less than a dollar for every dollar invested. Large institutions such as pension funds and college endowments withdrew money from money market funds and individual investors followed.[29] Many investors who withdrew from stocks and money market funds retreated to the safety of short-term Treasury bills, whose yields then dropped near to zero.[30]

In addition to these threats to the credit markets, some people believed that there were concerted efforts to decimate once strong financial institutions.[31] Some complained that short-sellers unfairly targeted particular companies to force their share prices lower and thereby make a profit themselves. Because of these complaints, the federal government temporarily banned short sales of 799 financial stocks.[32] In addition, the Securities and Exchange Commission and the New York State Attorney General vowed to investigate potential abuse of short selling.[33]

Despite various conspiracy theories, however, the most significant cause of the current credit crisis remained clear: Too many financial institutions were allowed to take on excessive leverage, and once the housing bubble burst, the illiquid leftover debt acted as a vise on credit markets.

C. Resolving a Credit Crisis

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[28] Zuckerman, *Wall Street's Day of Reckoning*, *supra* note 7.

[29] Nocera, *supra* note 5.

[30] *Id*.

[31] Morgan Stanley's chief executive, while watching shares of his firm's stock plunge fifty percent in a single week, raged about a conspiracy and called Christopher Cox, the chairman of the Securities and Exchange Commission, to advocate for a ban on short-selling. *See id.*

[32] "Short selling—a bet that a stock price will decline—is the practice of selling stock without owning it, hoping to buy it later at a lower price and thus make a profit." Vikas Bajaj & Graham Bowley, *S.E.C. Temporarily Blocks Short Sales of Financial Stocks*, N.Y. TIMES, Sept. 20, 2008, *available at* http://www.nytimes.com/2008/09/20/business/20sec.html.

[33] New York state attorney general Andrew M. Cuomo likened short sellers to "looters after a hurricane." *Id.*

The United States has suffered credit crises in the past and each time struggled toward recovery. The government's particular strategy for intervention or inaction, however, has drastically affected the length and severity of the crisis.

During the Great Depression of the 1930's, thousands of banks failed and billions of dollars in assets were lost. Despite widespread panic and a dwindling money supply, the Federal Reserve did not intervene.[34] By late 1930, panicked investors spurred a run on banks, forcing hundreds to close.[35] The Federal Reserve allowed these banks to fail. In hindsight, the choice appeared disastrous. The recession, which might have lasted a year or two, instead lasted a decade.[36] Had the Federal Reserve instead provided emergency lending to key banks or injected the markets with liquidity, the money supply would not have shrunk as drastically and fewer banks would have failed.[37] Yet the Federal Reserve's policy of inaction left little money circulating. Businesses found themselves unable to acquire loans and most were forced to stop investing.[38] Financial markets did not truly begin to recover until 1939, when production to support the war effort stimulated economic growth.

More recently, the United States savings and loan collapse in the 1980's sparked a credit crunch that then contributed to a recession in 1990 and 1991. Like the current crisis, the savings and loan collapse was fueled in large part by risky real estate lending.[39] Although savings and loan institutions performed functions similar to

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[34] *See generally* Paul Krugman, *Who Was Milton Friedman?*, N.Y. REV. OF BOOKS, Feb. 15, 2007, *available at* http://www.nybooks.com/articles/19857 (observing that noted economists Friedman and Schwartz argued that the Federal Reserve could have prevented the fall in the money supply and thus kept an otherwise ordinary recession from reaching catastrophic proportions).

[35] David Leonhardt, *Lesson From a Crisis: When Trust Vanishes Worry*, N.Y. TIMES, Oct. 1, 2008, at A1, *available at* http://www.nytimes.com/2008/10/01/business/economy/01leonhardt.html (comparing the current credit crisis to the Great Depression).

[36] Krugman, *supra* note 34.

[37] *Id*.

[38] Leonhardt, *supra* note 35.

[39] L. William Seidman, Former Chairman, Fed. Deposit Ins. Corp., *Lessons of the Eighties: What Does the Evidence Show?*, Address Before NIKKIN, 7th Special Seminar on International Finance (Sept. 18, 1996), at 57, *available at* http://www.fdic.gov/bank/historical/ history/vol2/panel3.pdf.

banks, they were far less regulated. When overwhelmed by debt, these institutions were not forced to acknowledge their insolvency. Many known problematic institutions were permitted to continue excessive and risky lending practices for years before they suffered huge losses.[40] Had regulators intervened earlier to stabilize problematic institutions, they may have prevented the fall of about 2000 savings and loan associations[41] and billions of dollars in losses.

The current crisis, which has already cost far more than the savings and loan collapse, will likely be felt for years. Several changes in monetary and fiscal policy, however, might shorten its course and soften its consequences. Both the housing and the financial markets failed to regulate themselves, and past credit crises have revealed the tremendous cost of inaction. Thus, a virtual laundry list of regulations now appears prudent: more stringent mortgage requirements, limits to the amount of leverage carried by financial institutions,[42] modification or elimination of the practice of short selling, and more transparent methods of evaluating underlying assets of complex debt securities.[43]

Regulatory changes, however, will do little to rectify the immediate crisis. In the short-term, the government considered, but later abandoned, the prospect of removing illiquid subprime assets from struggling banks in a bailout plan totaling more than $700 billion.[44] Yet despite a variety of extraordinary measures by the Federal Reserve to ease the credit crunch, merely throwing money at the crisis, or lowering interest rates to prop up credit markets, induces a false sense of security that only makes markets more vulnerable to a future crisis.[45]

By October of 2008, the credit crisis clearly had moved beyond the United States and demanded an aggressive global

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[40] Years later, as a cautionary lesson, Seidman acknowledged that in "[I]nsolvent banks require government action, tailored to fit the individual situation, and the longer the corrective action is delayed the more costly and destabilized the problem will be." *Id.* at 60.

[41] *Id.* at 55.

[42] *See* Walter Hamilton, *High-risk, Big-bucks Era Wanes on Wall Street*, L.A. TIMES, Sept. 21, 2008, *available at* http://www.latimes.com/business/la-fi-future22-2008sep22,0,6013126.story (stating that many investment banks often owed more than twenty-five times their net worth).

[43] *See* Zuckerman, *Wall Street's Day of Reckoning*, *supra* note 7.

[44] *Id*.

[45] *Credit and Blame*, *supra* note 9.

response. Without coordinated international stimulus programs and recapitalization efforts, little could prevent some countries from preying upon their neighbors.[46] Moreover, worldwide panic made a global response essential to curb stock market sell-offs and bank runs.[47] On October 8, central banks around the world cut short-term interest rates in an attempt to prop up stock markets and to facilitate lending.[48] Nonetheless, stock markets continued to spiral downward and large corporations and banks struggled to complete even routine business transactions.[49] Thus, the responses to the crisis so far, although significant, have yet to thaw frozen national and international credit markets, which indicates that much more will need to be done.

As credit markets continue to falter, the United States would benefit from an examination of other countries' reactions during credit crunches. Sweden provides a successful model of management of a similar credit crisis. In the 1990's, after years of disastrous deregulation and its own property boom and bust, Sweden's banking system was in ruins.[50] Rather than merely bail out failing financial institutions, the Swedish government forced banks to write down losses and issue warrants to the government.[51] The government became an owner of these institutions and later profited from the sale of distressed assets.[52] American taxpayers could urge the United States government to follow a similar model, extracting equity from banks in return for their rescue.

Conversely, the plodding response to Japan's economic collapse in the 1990's offers a cautionary tale. After a similar real estate bubble burst, Japan's government reacted slowly to the

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[46] *See* C. Fred Bergsten & Arvind Subramanian, *Globalizing The Crisis Response*, WASH POST, Oct. 8, 2008, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2008/10/07/AR2008100702440_pf.html.
[47] *Id.*
[48] Bradsher et al., *supra* note 8.
[49] *Id.*
[50] Carter Dougherty, *Stopping a Financial Crisis, the Swedish Way*, N.Y. TIMES, Sept. 22, 2008, at C9, *available at* http://www.nytimes.com/2008/09/23/business/worldbusiness/23krona.html (suggesting that the United States could learn from the Swedish management of financial crisis in the 1990's).
[51] *Id.*
[52] *Id.*

mounting financial crisis. The result was Japan's "lost decade," a humiliating and long-lasting economic slump.[53] \

D. Conclusion

The United States government, although slow to recognize the danger of risky lending practices and rising leverage, appeared to have adopted an aggressive stance by September 2008. The Bush administration, after years of leaving the markets to their own devices, interceded repeatedly to save failing financial institutions or to ease their sale to avoid outright bankruptcy. But perhaps underestimating the scope of the current crisis or overestimating the impact of his administration's recovery efforts thus far, President Bush announced, "We have shown the world that the United States will stabilize our financial markets and maintain a leading role in the global economy."[54] Around the world, investors and consumers alike wait, hoping that the country will.

Lisa Sutton[55]

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[53] Steve Lohr, *From Japan's Slump in 1990's, Lessons for U.S.*, N.Y. TIMES, Feb. 9, 2008, *available at* http://www.nytimes.com/2008/02/09/business/worldbusiness/09japan.html?pagewanted=1&adxnnlx=1223218845=xsxggpx9G1j3/CbqDR/u6g.

[54] David M. Herszenhorn, *Bailout Plan Wins Approval; Democrats Vow Tighter Rules*, N.Y. TIMES, Oct. 4, 2008, at A1, *available at* http://www.nytimes.com/2008/10/04/business/economy/04bailout.html?bl&ex=1223265600&en=80352c05b6d4b135&ei=5087.

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II. The Federal Response to the Credit Crisis

A. Introduction

The United States federal government has always understood that the importance of credit is not limited to a purely economic function. As Senator Daniel Webster suggested over 170 years ago, the urgency for the country to keep afloat its credit system was as much of a concern for national security as it was for the economic health of the nation. [1] This same concern exists today as the 2008 presidential election required candidates to address voters' fears that the credit crisis could affect our status in the world and thereby make us vulnerable to outside pressures. Our government leaders understand the electorate's fears, which should make the recent federal response to the credit crisis come as no surprise. What has been shocking, however, is the magnitude of the government response. The measures authorized by Congress and executed under President George Bush's administration are extraordinary in scope. With no end in sight for the economic breakdown domestically or globally, no one is certain if these actions will be effective or even if they will be the last the government will take. This article will attempt to shed light on the actions of key segments of the U.S. government in response to the credit crisis and their effect on the market.

B. Government Response

1. Congress

On September 20, 2008, President George Bush announced he would instruct the Secretary of the Treasury, Henry Paulson, to bailout struggling financial institutions by purchasing the distressed mortgages that caused the credit crisis.[2] The bailout proposal, or the

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[1] Sen. Daniel Webster, Speech given on March 18, 1834 on the Senate floor given in support of renewing the charter for the Bank of the United States, *in* 7 THE WRITINGS AND SPEECHES OF DANIEL WEBSTER 89 (National Ed., Little, Brown, & Company 1903).

[2] David M. Herszenhorn, *Administration Is Seeking $700 Billion for Wall Street*, N.Y. TIMES, Sept. 21, 2008, at A1, *available at* http://www.nytimes.com/2008/09/21/business/21cong.html?n=Top/Reference/Times%20Topics/People/L/Labaton,%20Stephen.

Emergency Economic Stabilization Act of 2008 ("Act"), called for the Treasury to use $700 billion to buy troubled mortgage securities that had caused the current market problems.[3] To provide funding for this proposal, the President requested Congress to increase the debt ceiling from $10.6 trillion to $11.3 trillion, in turn allowing the Treasury to use debt as a source of funding for the bailout.[4] After two weeks of debate to include restrictions on the Treasury Department's powers to prevent misuse of taxpayer money, the Senate and House of Representatives passed the bailout bill on October 1, 2008 and October 3, 2008, respectively.[5] Per the terms of the bill, the Treasury was commissioned to act with $350 billion effective immediately and Congress retained veto power over the remaining $350 billion.[6]

Despite the dire credit situation, several contentious issues arose during the Congressional debates, leading to the bill's two-week passage time. One of the most controversial pieces concerned executive pay.[7] As many Americans have been appalled by the level of pay on Wall Street, Congressmen wanted to make sure that the executives of companies benefiting from the Act would not be overcompensated through taxpayer money.[8] In response, Congress enacted provisions in the legislation to limit such pay.[9] Congress categorized companies based on whether the Treasury would buy the troubled assets from the company through an auction or invest in the company as an equity investor.[10] Congress provided clear language concerning executive pay for companies that sell mortgages to the government through an auction. The detailed guidelines state that companies that auction off more than $300 million in assets to the government "would not be able to deduct any salary or deferred compensation of more than $500,000, and top executives would face a 20% excise tax on golden parachute payments if they left for any

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[3] *Id.*
[4] *Id.*
[5] David M. Herszenhorn, *Bailout Wins Approval; Democrats Vow Tighter Rules*, N.Y. TIMES, Oct. 4, 2008, at A1, *available at* http://www.nytimes.com/2008/10/04/business/economy/04bailout.html?scp=1&sq=Bailout%20Wins%20Approval&st=cse.
[6] *Id.*
[7] Jim Puzzanghera, *Exec Pay Language Raises Questions*, L.A. TIMES, Sept. 29, 2008, at C1.
[8] *Id.*
[9] *Id.*
[10] *Id.*

reason other than retirement."[11] In situations where the government will buy an equity stake in the company, executives will not receive incentives for taking "'unnecessary and excessive risks' and would have to give up or repay bonuses or other incentives based on financial statements that 'are later proven to be materially inaccurate.'"[12] Unlike the language that limits the executive compensation for companies that sell their assets through auction but leaves the amount of risks they can take in the hands of the companies, the language concerning executive pay for companies in which the government will have an equity stake takes a stricter approach by allowing scrutiny as to whether the executive's bonus is based on "unnecessary and excessive risks."[13]

2. Executive Agencies

a. The Treasury Department

To implement the Act passed by Congress, the Treasury Department set up the Troubled Asset Relief Program ("TARP").[14] The program's goal is to inject liquidity into a market plagued with mortgage-backed securities ("MBS") that are stifling the credit market.[15] To assist the Treasury with its goal, the Act allows the Department to seek out private financial advisers who will determine how the government should invest the initial $350 billion.[16] In the hope of ridding the market of the troubled assets, the advisors will have the power to buy residential MBS, commercial MBS, and MBS collateralized debt obligations of varying quality that were issued on or before March 14, 2008.[17] Hundreds of advisors have submitted

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[11] *Id.*
[12] *Id.*
[13] *Id.*
[14] U.S. TREAS., NOTICE TO FINANCIAL INSTITUTIONS INTERESTED IN PROVIDING SECURITIES ASSET MANAGEMENT SERVICES FOR A PORTFOLIO OF TROUBLED MORTGAGE-RELATED ASSETS 1 (2008), http://www.treas.gov/initiatives/eesa/docs/notice_securities-asset-mgr.pdf [hereinafter TREASURY NOTICE].
[15] *Id.* at 2.
[16] *Id.*
[17] *Id.*

their bids to the Interim Assistant Secretary of Financial Stability, Neel Kashkari.[18]

While TARP will take time to implement, the Treasury has undertaken other measures in the meantime to shore up credit in the banking system. Under its first exercise of the bailout's funds, the Treasury effectively demanded the nation's nine largest banks sell to it $250 billion worth of preferred shares.[19] The preferred shares will pay out at a dividend of 5 percent for the first five years and 9 percent after that, thereby providing an incentive for the banks to raise capital and buy the government out of its stake before the 9% provision takes effect.[20] In addition to the $700 billion bailout, the Treasury has also guaranteed $1.5 trillion in senior debt issued by banks and insured $500 billion in noninterest-bearing accounts, bringing the Treasury's efforts to a total of almost $2.25 trillion in relief.[21] Despite the magnitude of its efforts, the Treasury has indicated its willingness to employ additional strategies, stating, "The Treasury may decide to include other types of securities in the portfolio as necessary to promote market stability" and that "specific investment strategies may change over time."[22]

b. The Federal Reserve

The Federal Reserve ("Fed") responded to the credit crunch as early as December 21, 2007, when they created the Term Auction Facility ("TAF"), a temporary program that is still in effect. TAF auctions funds to depository institutions below the discount rate in the hopes of improving the liquidity in the short-term funding markets that is crucial to banks' daily operations.[23] The Fed recently announced that it would increase this program from $300 billion to

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[18] Charlie Savage & Ben White, *Bailout Role Elevates U.S. Official*, N.Y. TIMES, Oct. 9, 2008, at B1, *available at* http://www.nytimes.com/2008/10/09/business/09kashkari.html.
[19] Mark Landler & Eric Dash, *Drama Behind a $250 Billion Banking Deal*, Oct. 15, 2008, at A1, *available* at http://www.nytimes.com/2008/10/15/business/economy/15bailout.html.
[20] *Id.*
[21] *Id.*
[22] TREASURY NOTICE, *supra* note 14, at 2.
[23] Press Release, Federal Reserve Board, Federal Reserve Intends to Continue TAF Auctions as Necessary (Dec. 21, 2007), http://www.federalreserve.gov/newsevents/press/monetary/20071221b.htm.

$600 billion.[24] Shoring up this short-term debt is important as banks rely on unsecured short-term debt to fund their daily operations. To that end, the Fed took further action in creating the Commercial Paper Funding Facility, which would buy three-month unsecured and asset-backed commercial paper directly from companies.[25]

As the end of the year approaches and banks try to balance their sheets, the Fed is also ready to provide an additional $300 billion to help banks meet their end-of-the-year cash needs.[26] While the Fed already loaned American International Group ("AIG") $85 billion so it could buy back its fixed-income securities to replenish the company's liquidity, the Fed announced that it would loan an additional $37.8 billion to the insurance conglomerate.[27] These actions brought the Fed's spending to more than $1 trillion, all of which are in addition to the Treasury's $2.25 trillion efforts as noted in the previous section.

Additionally, the Fed's Federal Open Market Committee ("FOMC") voted to decrease the federal funds rate by 50 basis points to 1.5 percent on October 8, 2008.[28] When approving the new lower federal funds rate, the FOMC cited the need to help businesses and households to obtain the credit they need.[29] The Fed hopes to increase the availability of credit to households and businesses by giving incentives to consumers to take on debt at lower interest rates and for banks to hold cash reserves instead of treasury securities.[30] Through the Fed's lending efforts and the lowering the federal funds rate, the Fed has demonstrated that it has the ability to take temporary short-term actions that have an immediate impact on the economy compared to the bailout plan that is to be implemented by

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[24] Edmund L. Andrews & Michael M. Grynbaum, *Fed Announces Plan to Buy Short-Term Debt*, N.Y. TIMES, Oct. 7, 2008, at A1, *available at* http://www.nytimes.com/2008/10/08/business/08fed.html.
[25] *Id*.
[26] *Id.*
[27] Press Release, Bd. of Governors of the Fed. Reserve Sys., Board Authorizes Federal Reserve Bank of New York to Borrow Securities from Certain Regulated U.S. Insurance Subsidiaries of AIG (Oct. 8, 2008), http://www.federal reserve. gov/newsevents/press/other/20081008a.htm.
[28] Press Release, Bd. of Governors of the Fed. Reserve Sys., Federal Reserve and Other Central Banks Announce Reductions in Policy Interest Rates (Oct. 8, 2008), http://www.federalreserve.gov/newsevents/press/monetary/20081008a.htm.
[29] *Id.*
[30] *Id.*

the Treasury, which could take months to have a definite form and shape.

3. The Next Administration

President-elect Barack Obama voted in favor of the bailout bill on October 2, 2008.[31] Obama's plans, however, do not call for further intervention with already-issued subprime mortgages other than what was in the bailout bill. His proposals look to prevent a crisis like this from reoccurring in the future. Obama has proposed a STOP FRAUD Act, which would include the first federal definition of mortgage fraud, increase funding for enforcement agencies to combat mortgage fraud, and require those in the mortgage industry to report suspicious activity.[32] In addition to home mortgages, Obama wants to create a "Credit Card Bill of Rights" that would protect consumers by banning unilateral changes to credit agreements by lenders, restricting increased interest rates to future debt, and prohibiting interest on fees.[33] While future regulatory measures are important, Obama's views on the proper use of TARP, however, are still somewhat unclear. Though he has supported the bailout package, there has not been much discussion as to how he will order the Treasury to execute the bailout.

C. Reaction to Government Action

1. Critics' Response

Free market proponents are wary of the recent bailout legislation and have questioned the need for the $700 billion package. These opponents of a bailout argue that such action creates a "moral hazard" by paying for the mistakes of those who either loaned or were leant subprime mortgages despite all the risk.[34] By

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[31] Carl Hulse, *Pressure Builds on House After Senate Backs Bailout*, N.Y. TIMES, Oct. 2, 2008, at A1, *available at* http://www.nytimes.com/2008/10/02/business/02bailout.html.
[32] *Economy*, BARACKOBAMA.COM, http://www.barackobama.com/issues/economy/#home-ownership (last visited Oct. 27, 2008).
[33] *Id.*
[34] Eric Weiner, *Subprime Bailout: Good Idea or 'Moral Hazard?'*, NAT'L PUB. RADIO, Nov. 29, 2007, http://www.npr.org/templates/story/story.php?storyId=16734629.

bailing out the banks, the government will not provide the finance industry with the right incentives to not engage in this activity again.[35] In addition, since the Fed is willing to loan up to $1 trillion, at least one expert believes the $700 billion may be unnecessary to help the markets improve.[36] Actions such as the Fed's might be enough to instill confidence in the market and turn stocks around without the injection of $700 billion of liquidity to the banks.

While academics debate how the finance industry will behave in the future knowing the government might step in to rescue them, the American electorate at large wait to see if the executive pay provisions of the Act will save the banking industry while not providing excessive pay to the Wall Street executives who have received public taxpayer money. The limitation on pay is particularly important since the investors in this case are not risk-seeking shareholders but rather ordinary taxpayers. Provisions to limit executive pay, however, are not new. Congress first passed limited on the tax deductibility of executive salaries in 1993,[37] and critics correctly predicted that such limits on tax deductibility would lead to an increase in the use of stock options to compensate executives.[38] While the Act in some situations requires executives who take "unnecessary and excessive risks" to repay any bonuses that they received in connection with those risks, the provision only applies to companies in which the government will buy an equity stake. Furthermore, in the situations where it will apply, the vagueness of the language leaves room for debate as to what is an "unnecessary and excessive risk" for a company. Such vague language makes it certain that litigation will ensue as to the meaning of this provision and its application to bonuses from executives who continue to engage in the same risky behavior while receiving taxpayer help.

2. Market Response

As the government has taken action to shore up confidence in the weakened economy, it is important to look at the response of the targets of this legislation. Unfortunately, the market has

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[35] *Id.*
[36] Jeremy Caplan, *Why the $700 Billion Isn't Helping*, TIME.COM, Oct. 7, 2008, *available at* http://www.time.com/time/business/article/0,8599,1847978,00.html.
[37] Puzzanghera, *supra* note 7.
[38] *Id.*

responded poorly to the recent measures taken by the government. The Dow Jones Industrial Average fell below 10,000 points for the first time in four years.[39] While it has leveled off from its dramatic drops, the market has yet to recover to levels seen in recent years. In addition, banks lending to other banks and consumers has virtually stopped, forcing the Fed to guarantee short-term security debt.[40] As economic indicators point downward, the government may need to consider additional avenues to stabilize the American economy.

D. Conclusion

The federal government has responded relatively quickly to the current credit crisis as compared to its normal response time to national issues. The swift response might be due to the immediacy of the crisis or the nature of the business world itself, with one bad day on Wall Street leading to lower confidence on the trading floor the next day with little time to rest in between trading periods. Whatever the reason for its swift actions, the Congress and the relevant executive agencies have provided the economy with trillions of dollars of loans in the hopes that the economy will improve through its efforts and the taxpayers will recoup their money, thereby, avoiding another Great Depression. Whether this plan for the government to invest in our financial institutions will work to improve the economy, is the one, single question that looms over the federal response. Will the response revive the economy or will the banks continue to fail and waste taxpayer money furthering the crisis? In an ever globally connected world, the federal response might not be enough to save the American marketplace when the health of other markets, such as those in Europe and Asia, have also not fared well in the credit crisis. With such a global collapse, the credit crisis may be a situation where America cannot go at it alone.

Costantino Panayides[41]

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[39] Joe Gould & Corky Siemaszko, *Wall Street Tumbles Amid Global Stocks Sell-Off*, U.S. NEWS & WORLD REP., Oct. 6, 2008, http://www.usnews.com/articles/business/economy/2008/10/06/wall-street-tumbles-amid-global-stocks-sell-off-dow-drops-below-10000.html.

[40] Andrews & Grynbaum, *supra* note 24.

[41] Student, Boston University School of Law (J.D. 2010).

III. The Bailout of Fannie Mae and Freddie Mac

A. Introduction

On July 30, 2008, Congress passed the Housing and Economic Recovery Act of 2008 ("HERA") authorizing a U.S. Treasury plan to allow the government, through the newly created Federal Housing Finance Agency ("FHFA"), to purchase stock in the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac").[1] On September 7, U.S. Secretary of the Treasury Henry Paulson announced the commencement of the takeover and effectively placed both corporations into a conservatorship.[2] The necessity of government oversight of both corporations, which finance almost seventy percent of the country's consumer and residential mortgages, was apparent in the months leading up to Treasury action.[3] Factors including the effects of the 2007 subprime mortgage crisis, foreign investors' loss of confidence in the corporations and consumers' reliance on the corporations delineate the necessity of Treasury involvement.

This article will provide a comprehensive understanding of Fannie Mae and Freddie Mac's takeover. It will first look at the history of Fannie Mae and Freddie Mac and the economic and social factors that led up to the Treasury takeover. Next, it will introduce the specificities of the takeover plan, its affects on stakeholders and the viability of the plan's success. Finally, it will discuss the future of the corporations. The conservatorship is a temporary solution, and regardless of its immediate success in establishing stability, the corporations will most likely face liquidation, nationalization or privatization after the 2008 presidential election. Which fate provides the most efficient and efficient structure for the government, private

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[1] DechertOnPoint, *Treasury Department Releases Plan for Takeover of Fannie Mae and Freddie Mac* (Sept. 2008), *available at* http://www.dechert.com/library/FS_FRE-09-08-08.pdf.

[2] Press Release, Fed. Hous. Fin, Agency, Statement by Henry M. Paulson, Jr., U.S. Sec'y of the Treasury, on Treasury and Federal Housing Finance Agency Action to Protect Financial Markets and Taxpayers (Sept. 7, 2008) [hereinafter Statement by Secretary Paulson].

[3] Jessica Holzer, *Takeover May Help Homebuyers, Hit Fan-Fred Shareholders*, WALL ST. J. ONLINE, Sept. 6, 2008, http://online.wsj.com/article/SB122073569345807283.html.

investors, consumers and taxpayers? The corporations evolved from government-backed entities to government-sponsored entities ("GSEs"), and thus the natural step would be to complete their privatization and allow the free market to control their stability.

B. History of Fannie Mae and Freddie Mac

President Franklin D. Roosevelt founded Fannie Mae and Freddie Mac in 1938 as part of his "New Deal" legislation to serve as mortgage lenders for consumers and potential home buyers.[4] In 1968, the corporations were privatized following general concern that keeping lending institutions on the government's balance sheet would create housing market instability; the corporations then rescinded responsibility of guaranteeing government-issued mortgages after privatization.[5] Despite these infrastructure changes, the mission to stabilize mortgages and increase liquidity remained the same, and by 2008 Fannie Mae and Freddie Mac owned $5.4 trillion of guaranteed mortgage backed securities ("MBS").[6]

In order to comprehensively understand the implications and future ramifications of the September 8 takeover of Fannie Mae and Freddie Mac, it is essential to understand the business model under which the companies thrived. The corporations do not make loans or secure mortgages directly with consumers in the primary mortgage market but instead satisfy a necessary niche in the secondary mortgage market.[7] They purchase and repackage loans from banks and other mortgage originators and sell them with a guarantee against interest and principal default.[8] After banks and other loan originators sell mortgages to Fannie Mae and Freddie Mac, they use profits to make new loans.[9] New loans increase liquidity and flexibility in the housing market, making it seemingly easier for consumers to obtain

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[4] Kate Pickert, *A Brief History of Fannie Mae and Freddie Mac*, TIME.COM, July 14, 2008, http://www.time.com/time/business/article/0,8599,1822766,00.html.
[5] *Id.*
[6] Press Release, Fed. Hous. Fin. Agency, Statement of FHFA Dir. James B. Lockhart (Sept. 7, 2008) [hereinafter Statement of FHFA Director Lockhart].
[7] Pickert, *supra* note 4.
[8] Charles Duhigg, *Loan-Agency Woes Swell From a Trickle to a Torrent*, N.Y. TIMES, July 11, 2007, at C1.
[9] *Id.*

mortgages and invest in the housing market. Although the companies were successful in bolstering the housing market, the 2007 mortgage crisis and resulting foreign shareholder divestment resulted in one the largest Treasury interventions in the private financial market in U.S. history.

C. The Impact of the 2007 Mortgage Crisis

Fannie Mae and Freddie Mac are expected to further both the government's goals of providing financing for housing consumers and stockholders' goals of increasing profits when investing capital into the housing industry.[10] The U.S Department of Housing and Urban Development ("HUD") enlisted Fannie and Freddie's aid in their mission to increase low and middle-income family home ownership.[11] In 2004, HUD required Fannie Mae and Freddie Mac to purchase "affordable" loans made available to these low and middle-income borrowers.[12] In return, HUD allowed the corporations to place billions in subprime loans on their balance sheet; however, HUD had not examined whether borrowers could in fact make these "affordable" loan payments.[13] Additionally, Fannie Mae and Freddie Mac offered eligible families a thirty-year fixed-rate mortgage with a low down payment and a continuous availability of mortgage credit.[14] Although the companies were successful in their aid to HUD, the victory was short lived.[15]

The subprime mortgage crisis began at the end of 2006 after the housing boom hit its peak in 2005 and subsequently began to decline.[16] Despite its decline, the subprime mortgage crisis that two

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[10] Floyd Norris, *The Dilemma of Fannie and Freddie*, N.Y. TIMES, Sept. 8, 2008, at C1.

[11] U.S. Dep't of Hous. and Urban Dev., Housing Goal Tables (2002), *available at* http://www.hud.gov/offices/hsg/gse/reports/2002aharfnmapublictables.pdf.

[12] Carol D. Leonnig, *How HUD Mortgage Policy Fed the Crisis,* WASH. POST, June 10, 2008, at A01.

[13] *Id.*

[14] U.S. Dep't of Hous. and Urban Dev., Freddie Mac's Annual Housing Activities Report for 2002 (March 17, 2003), *available at* http://www.hud.gov/offices/hsg/gse/reports/2002aharfmacnarrative.pdf.

[15] Justin Lahart, *Egg Cracks Differ In Housing, Finance Shells,* WALL ST. J., Dec. 23, 2007, at C1.

[16] *Id.*

long-term effects: a high rate of loan defaults and the loss of investor confidence.

1. High Rate of Loan Defaults

In June 2006, sales of both existing and new single-family homes fell 9 percent and 15 percent respectively.[17] This implicated Fannie Mae and Freddie Mac in several ways—between 2004 and 2006, the companies purchased $434 billion in securities backed by subprime loans, which opened up capital flow for more lending.[18] However, the loans' high interest rates and low- and middle- income families' inability to make payments caused foreclosure numbers to skyrocket.[19] By the end of 2007, three to four million families were expected to lose their homes through foreclosure with the low and middle-income homebuyers defaulting at a rate three times faster than other borrowers.[20] Increased foreclosure caused depreciation of home prices and resulted in losses for GSEs like Fannie Mae and Freddie Mac.[21] In order to alleviate consumer and investor panic, and to curb the extent of the crisis and loan defaults, Congress passed HERA.[22] The act approved the government's purchase of Fannie Mae and Freddie Mac stock, temporarily increasing their credit lines.[23] Yet, HERA could not combat the second dispositive impact of the subprime mortgage crisis: loss of investors' confidence.

2. The Effect of Investors' Loss of Confidence

Fannie Mae and Freddie Mac can offer secure loans and mortgages because of investor capital, but problems arise when indispensable investors begin to lose faith.[24] In the weeks preceding the takeover, debt holding foreign investors reduced their investment

[17] *Id.*
[18] Leonnig, *supra* note 12.
[19] *Id.*
[20] *Id.*
[21] Duhigg, *supra* note 8.
[22] DechertOnPoint, *supra* note 1.
[23] *Id.*
[24] Duhigg, *supra* note 8.

in the corporations responding to the high number of foreclosures.[25] The Bank of China, the largest Chinese holder of Fannie Mae and Freddie Mac securities, substantially decreased its debt held from $20 billion at the end of 2007 to $17.3 billion by June 30, 2008 and additionally sold or matured $4.6 billion of its 2008 holdings.[26] Attempting to limit further debt retraction by foreign investors, Undersecretary for International Affairs David McCormick called foreign central banks and other foreign investors in efforts to reassure Fannie Mae and Freddie Mac's stability.[27] Additionally, foreign investors assumed that investments in Fannie Mae and Freddie Mac would be secured by the U.S. government, which in reality was not the case.[28] These factors led to a substantial decrease in debt investment indirectly exacerbating the credit crisis.[29]

D. The Takeover Plan

The long-term effects of the subprime mortgage crisis catalyzed the need for the takeover of Fannie Mae and Freddie Mac. Under the takeover plan, Fannie Mae and Freddie Mac were placed into a conservatorship under the authority of the FHFA.[30] The takeover plan consists of four phases: (1) placing Fannie Mae and Freddie Mac into a conservatorship; (2) creating preferred stock plans by the Treasury; (3) allowing the Treasury to purchase MBS issued by Fannie Mae and Freddie Mac; and (4) establishing a secured credit facility where the Treasury will make loans available to the companies.[31]

1. Conservatorship

The purpose of the conservatorship is to preserve and conserve assets and put both Fannie Mae and Freddie Mac in a sound and solvent condition. To that end, under the conservatorships, the FHFA assumed control of the operations of both corporations and

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[25] Deborah Solomon et al., *Mortgage Bailout Is Greeted With Relief, Fresh Questions*, WALL ST. J., Sept. 9, 2008, at A1.
[26] *Id.*
[27] *Id.*
[28] *Id.*
[29] Holzer, *supra* note 3.
[30] *Id.*
[31] DechertOnPoint, *supra* note 1.

now exercise all powers held collectively by the shareholders, directors, or officers of the companies. First, the FHFA changed corporate leadership in the GSEs, appointing Herb Allison and David Moffett as CEOs of Fannie Mae and Freddie Mac, respectively.[32] In addition, as the FHFA exercises shareholder power, stock will continue to trade only with suspended voting rights and dividends payments. Lastly, the FHFA will collect all obligations and money due to the corporations, perform all functions of corporations that are consistent with each company's appointment, and preserve and conserve assets and property.

2. Preferred Stock Purchase

The Treasury established a preferred stock plan where the government will receive senior preferred stock in exchange for a potential $100 billion investment in each corporation.[33] In order to reassure worried taxpayers that government investments will not jeopardize their tax money, the Treasury diluted and subordinated the interests and rights of already existing common and preferred shares.[34] The senior preferred stock enjoys no voting rights and repayment will begin March 31, 2010.[35] In addition to the senior preferred stock, the Treasury will also receive warrants equaling 75 percent of both companies common stock and require both corporations to confer with the Treasury Department before undertaking certain actions including payment or purchase of capital stock, issuing capital and entering into compensation agreements.[36]

3. Treasury Purchase of New MSB Offerings and Available Credit Facility

Beginning in September 2007, the takeover allowed the Treasury to purchase Fannie Mae and Freddie Mac issued MBS.[37] Increased MBS purchase will increase capital available to fund

[32] Eric Dash, *Few Stand to Gain on This Bailout, and Many Lose*, N.Y. TIMES, Sept. 8, 2008, at C1.
[33] DechertOnPoint, *supra* note 1.
[34] *Id.*
[35] *Id.*
[36] *Id.*
[37] DechertOnPoint, *supra* note 1.

mortgages for homeowners and prospective buyers.[38] The Treasury will hold purchased securities until maturity.[39]

Lastly, the takeover plan establishes a secured credit facility where the Treasury makes loans available to companies and the Federal Home Loan Banks.[40] The purpose is to preserve, create and increase in liquidity; the funding for the loans will come solely from the Treasury.[41]

E. Impact on Relevant Stakeholders

Analysis and debate over the efficacy of the takeover plan must begin with identifying the extent of impact on shareholders, taxpayers, the mortgage holders and the housing market.

Common shareholders felt some gains as well as losses. While the increase of government capital will raise the value of Fannie Mae and Freddie Mac stock, shareholders survived through a tumultuous summer of lower share prices.[42] Share prices plummeted approximately 90 percent this year and consequently eliminated approximately $70 billion in shareholder value.[43] On a more optimistic note, a conservatorship allows shareholders to keep their shares as long as the market allows, which contrasts the prospect of a more severe receivership that would liquidate all remaining shares after a similar takeover. Unfortunately, while holders of common stock can retain their shares, they will not have the same control in the corporation as voting rights are suspended in the takeover.[44]

Holders of preferred stock may suffer if the preferred stock is marked down or if the Treasury's preferred stock subordinates their shares in lieu of another credit crisis.[45] Fannie Mae and Freddie Mac currently have almost a combined $36 billion in outstanding preferred shares.[46]

Taxpayers may be concerned that they are funding what has become the biggest government intervention in a private financial

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[38] *Id.*
[39] *Id.*
[40] *Id.*
[41] *Id.*
[42] Dash, *supra* note 32.
[43] *Id.*
[44] Holzer, *supra* note 3; DechertOnPoint, *supra* note 1.
[45] Holzer, *supra* note 3.
[46] *Id.*

market. Critics assert that taxpayers are also contributing to the large and highly controversial severance packages of Fannie Mae and Freddie Mac's outgoing CEOs: Daniel Mudd of Fannie Mae collected $9.3 million and Richard F. Syron of Freddie Mac collected at least $14.1 million.[47] Secretary Paulson attempted to dissipate concern, commenting, "To the extent the taxpayers put funds in these companies, they will be repaid before the shareholders get a penny."[48]

The housing market, including old and new mortgage holders, will immediately feel both positive and negative effects of the takeover. The primary concern for consumers is how the takeover will affect mortgage rates. In the short term, fixed mortgage rates will not experience much change.[49] In fact, the takeover infuses millions of liquid capital into the mortgage market and will stabilize rates for potential homebuyers.[50] This stabilization will most likely attempt to combat the recent dip in the housing market. For example, the PNC Financial Group has already experienced a decreased interest rate from 6.125 percent to 5.875 percent on thirty-year fixed mortgages.[51] Current homeowners will most likely also benefit from the takeover, because the government has little interest in foreclosing on currently owned homes[52] Securing already existing mortgages was a primary goal of the takeover because increased foreclosure was identified as a dispositive factor in causing the 2007 mortgage crisis.[53] However, consumers attempting to acquire new loans and mortgages must be prepared for changes in future interests rates. Owners and potential buyers should expect changes in credit score requirements, ratios of loan size to home value, and down payment requirements.[54] There is little change to investment banks that are paid as debt underwriters.[55]

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[47] Dash, *supra* note 32.
[48] Maria Bartiromo, *Hank Paulson on the Housing Bailout and What's Ahead*, BUS. WK., Sept. 22, 2008, *available at* WLNR 17716291.
[49] Ron Lieber, *Fannie, Freddie and You: What It Means to the Public*, N.Y. TIMES, Sept. 8, 2008, at A1.
[50] *Id.*
[51] Solomon et al., *supra* note 25.
[52] Lieber, *supra* note 49.
[53] Norris, *supra* note 10.
[54] Lieber, *supra* note 49.
[55] Dash, *supra* note 32.

Lastly, the takeover extinguished the market for Washington lobbyists.[56] While in the last decade Fannie Mae and Freddie Mac paid $79.5 million and $94.8 million for government lobbying, respectively, the takeover plan has eliminated that spending.[57]

F. Viability of a Successful Takeover

It is difficult to discern the long-term efficacy of the takeover, but ideally, the takeover will strengthen Fannie Mae and Freddie Mac's ability to secure mortgages for current and prospective consumers. The government has pledged up to $200 billion between the two corporations to stabilize failing mortgages and lower mortgage and interest rates.[58] Lower mortgages rates would allow Fannie Mae and Freddie Mac to back more mortgages and loosen underwriting rules.[59] Additionally, consumers could purchase higher-valued homes with the same amount of initial capital—a percentage point decline in interest rates would equate the same monthly payment on a thirty year fixed loan as if the home price dropped ten percent.[60]

G. Future of Fannie Mae and Freddie Mac

The takeover serves as a temporary solution for Fannie Mae and Freddie Mac's credit crisis. The conservatorship is merely a transition before one of three fates: liquidation, nationalization or privatization.[61] Liquidation of either entity is nearly impossible. The political and financial pressure to save Fannie Mae and Freddie Mac because of the country's reliance on their secured lending is too great.[62] Thus, the two remaining options are to either nationalize or privatize Fannie Mae and Freddie Mac after the current conservatorship. While both options possess viable benefits, a higher

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[56] *Id.*
[57] *Id.*
[58] Solomon et al., *supra* note 25.
[59] *Id.*
[60] *Id.*
[61] Peter J. Wallison, *Fannie and Freddie by Twilight*, FIN. SERV. OUTLOOK, Aug. 26, 2008, *available at* http://www.aei.org/docLib/20080826_23427AugustFSO.pdf
[62] *Id.*

degree of privatization provides the strongest option for Fannie Mae and Freddie Mac.

Supporters of nationalization argue that because Fannie Mae and Freddie Mac serve a necessary purpose in the country's housing market, it is in the government's best interest to control the future stability of the entities.[63] In order to nationalize the entities, the government would either acquire all of the GSEs outstanding shares or place the entities in a receivership.[64] HERA authorizes the government to appoint a receiver if Fannie Mae and Freddie Mac are "critically undercapitalized" and unable to meet the mission of securing mortgages and increasing liquidity in the housing industry.[65] Yet nationalization, at its core, undermines the country's free market values. Government involvement additionally places a burden on taxpayers to supply capital to vitalize Fannie Mae and Freddie Mac and gives the government an enormous amount of control in the structure of the housing market, including determining who qualifies for mortgage lending.

Therefore, privatization is the better policy choice. Fannie Mae and Freddie Mac can set up state-chartered corporate parent companies that would eventually acquire the GSEs through shareholding.[66] Private sector subsidies and entities are more likely to have the capital and resources to purchase the portfolios and new securitizations. While opponents of privatization argue that Congress is hesitant to dissolve the GSEs and their provision of stability, political motives should not outweigh other taxpayer and private interests. Privatization would relieve taxpayer burden and allow the free market and shareholders to control the fate of Fannie Mae and Freddie Mac.

H. Conclusion

The ongoing debate regarding the past and future of Fannie Mae, Freddie Mac, and the recent takeover reaffirms the primary mission of the government regarding mortgage lenders: to increase the availability of mortgage finance and make mortgages secure and affordable. Tumultuous shifts in the economy in 2008 leave the government, shareholders and taxpayer contemplating the fate of

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[63] Wallison, *supra* note 61.
[64] *Id.*
[65] *Id.*
[66] *Id.*

Fannie Mae, Freddie Mac, and the health of the housing market. The government's ability to keep them in a conservatorship is limited. Eventually, the GSEs must either be nationalized or privatized. Political decision makers must keep consumers' reliance on the corporations at the forefront. Because the government, consumers and shareholders all separately rely on Fannie Mae and Freddie Mac, it is increasingly difficult to placate one interest group without negatively affecting another. The country will witness a formative transformation of two GSEs in the coming months. The implications will go beyond the impact on stakeholders discussed in this article. The outcome of Fannie Mae and Freddie Mac will illustrate the next political administration's stance on the housing industry, the role of GSEs and traditional free market values.

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IV. Parallels Between the Fannie and Freddie Debacle and the Savings and Loan Crisis of the 1980s

A. Introduction

The crisis facing the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac") has taken a form similar to the savings and loan debacle of the 1980s. Just as a series of legislative actions ultimately steered the savings and loan industry over a cliff,[1] policy decisions in the 1990s and early 2000s set Fannie Mae and Freddie Mac on course for disaster.[2] The federal government's response to the problems at Fannie Mae and Freddie Mac is also reminiscent of the government's intervention in the savings and loan industry two decades ago. Once the dire circumstances of the 1980s became apparent, government sprang into action to "rescue" the failed savings and loan industry.[3] Officials justified that bailout with rhetoric eerily similar to that of modern regulators as they explain the actions taken to bail Fannie Mae and Freddie Mac out of the mess the companies face.[4] Moreover, just as the savings and loan bailout left a path of destruction in its wake,[5] so too has the Fannie Mae and Freddie Mac bailout in part crushed investors.[6] History is indeed repeating itself as the mortgage market unravels.

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[1] *See* H.R. REP. NO. 101-54(I), at 294 (1989), *reprinted in* 1989 U.S.C.C.A.N. 86, 90.

[2] *See* Carol D. Leonnig, *How HUD Mortgage Policy Fed the Crisis*, WASH. POST, June 10, 2008, at A01; Steven A. Holmes, *Fannie Mae Eases Credit to Aid Mortgage Lending*, N.Y. TIMES, Sept. 30, 1999, at C5, http://query.nytimes.com/gst/fullpage.html?res=9C0DE7Db153EF933A0575AC0A96F958260.

[3] *See* H.R. REP. NO. 101-54(I), *supra* note 1.

[4] *Compare* Remarks on Signing the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, 2 PUB. PAPERS 1072 (Aug. 9, 1989) *with* Henry M. Paulson, Jr., U.S. Sec'y of Treasury, Statement on Treasury and Federal Housing Finance Agency Action to Protect Financial Markets and Taxpayers (Sept. 7, 2008), *available at* http://www.treas.gov/press/releases/hp1129.htm.

[5] *See* Note, *Unsecured Creditors of Failed Banks: It's Not a Wonderful Life*, 104 HARV. L. REV. 1052, 1052 (1991); H.R. REP. NO. 101-54(I), *supra* note 1, at 325, 121.

[6] *See* Google Finance Home Page, http://finance.google.com/finance (last visited Oct. 27, 2008).

B. Prelude to Disaster

1. Savings and Loan Industry

The story of the savings and loan collapse of the 1980s is one of an industry seeking to compete in a financial sector awkwardly managed, and ultimately fatally mismanaged, by government.[7] Rising interest and inflation rates combined with caps on the rate of return on deposits led to significant outflows of funds from banks and thrifts in the late 1970s and early 1980s.[8] Regulation Q restricted the interest rate that thrifts and other financial institutions could pay on deposits.[9] Investors understood that they lost money when inflation exceeded this constrained rate of return on their deposits, so they rationally shifted their funds away from depository institutions when inflation outpaced their returns.[10] This process, referred to as "disintermediation," resulted in credit shortages as banks and thrifts did not have the cash on hand to make loans.[11] Dependent on mortgage credit, the construction industry suffered.[12] Homebuyers were similarly hit hard by the lack of mortgage funds.[13] These developments forced Congress into action.[14]

Seeking to ease credit shortages by enabling banks and thrifts to attract deposits, Congress removed Regulation Q restrictions.[15] Unfortunately for thrifts, this meant they no longer enjoyed a twenty-five to fifty basis point advantage over banks on the rate they could pay on time and savings deposits.[16] Without Regulation Q, thrifts could pay higher rates and attract more deposits, but they had to compete on a level playing field with other financial institutions for deposits.[17] This meant thrifts were paying a higher price for deposits.[18]

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[7] *See* H.R. REP. NO. 101-54(I), *supra* note 1, at 294, 90.
[8] *Id.* at 295, 91.
[9] *Id.*
[10] *Id.*
[11] *Id.*
[12] *Id.*
[13] *Id.*
[14] *Id.*
[15] *Id.*
[16] *Id.* at 296, 92.
[17] *Id.*
[18] *Id.*

While facing higher costs to attract funds, thrift assets were confined to investments in low-yielding, fixed-rate long-term mortgages.[19] Thrifts could not adjust their portfolios to compensate for the increased expenses associated with attracting deposits.[20] The combination of more expensive deposits and low returns on assets led to significantly negative returns for the industry.[21] These losses, coupled with continued disintermediation, led to substantial numbers of thrift failures in the early 1980s.[22]

In response, Congress passed the Garn-St. Germain Depository Institutions Act of 1982,[23] which attempted to combat the outflow of deposits by authorizing thrifts to offer money market accounts to depositors with no interest rate limitations.[24] In addition, Garn-St. Germain substantially eased the investment restrictions on federally chartered thrifts.[25] Not to be outdone, many states followed suit by removing investment restrictions for state-chartered thrifts.[26] Indeed, by 1984, state-chartered thrifts in more than a third of the states received broader investment discretion than their federally chartered counterparts.[27]

This newfound investment freedom was placed in the hands of thrift managers who lacked the experience and expertise to properly utilize their new powers.[28] Together with the backstop of federally backed deposit insurance through the Federal Savings and Loan Insurance Corporation ("FSLIC"), this created a situation in which thrifts could invest recklessly without fear of governmental or market discipline.[29] Thrifts grew rapidly due partly to federally insured deposits, increased demand for mortgages as the economy recovered, and fewer restrictions on investments.[30] In a scenario familiar to contemporary readers, the loan portfolios of many of these thrifts were poorly collateralized.[31] Teetering on this weak

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[19] *Id.*
[20] *Id.*
[21] *Id.*
[22] *See id.*
[23] *Id.*
[24] *Id.*
[25] *Id.* at 297, 93.
[26] *Id.*
[27] *Id.*
[28] *Id.*
[29] *See id.*
[30] *Id.* at 299, 95.
[31] *Id.*

foundation, hundreds of thrifts eventually failed.[32] In the end, the FSLIC faced insolvency.[33]

2. Fannie Mae and Freddie Mac

The mortgage crisis facing Fannie Mae and Freddie Mac also has its roots in government mismanagement of markets.[34] The United States Department of Housing and Urban Development ("HUD") became the principle regulator for Fannie Mae and Freddie Mac in 1992.[35] Under HUD regulations, Fannie Mae and Freddie Mac were required to purchase mortgages made to low- and middle-income borrowers.[36] In 1995, HUD authorized Fannie Mae and Freddie Mac to count subprime mortgages toward these requirements for affordable mortgage purchases.[37] Four years later, Fannie Mae eased the credit requirements on loans it purchased from lenders.[38] In 2004, HUD raised its targets for the affordable-housing loans Fannie Mae and Freddie Mac were to purchase.[39] These measures forced Fannie Mae and Freddie Mac to take significant positions in the subprime mortgage market.[40]

The companies bought 44 percent of subprime securities available to the market in 2004, 33 percent in 2005, and 20 percent in 2006.[41] The risk of such action was recognized before the turn of the century and led commentators to draw analogies with the savings and loan crisis.[42] Despite such warnings, Congress failed to act on attempts at regulatory reform.[43]

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[32] *Id.*
[33] *Id.*
[34] *See, e.g.*, Leonnig, *supra* note 2.
[35] *Id.*
[36] *Id.*
[37] *Id.*
[38] Holmes, *supra* note 2.
[39] Leonnig, *supra* note 2.
[40] *Id.*
[41] *Id.*
[42] *See, e.g.*, Holmes, *supra* note 2.
[43] *See, e.g.*, Federal Housing Enterprise Regulatory Reform Act of 2005, http://www.govtrack.us/congress/record.xpd?id=109-s20060525-16 ("Status: Dead").

3. Comparing Policy Decisions Leading to the Crises

Each crisis arose because of government policies creating dangerous incentives. In the 1980s, thrift managers took advantage of federally backed deposits and eased investment restrictions as they took on ever-greater levels of risk with their portfolios and capital allocations.[44] The modern mortgage market meltdown followed decisions to encourage Fannie Mae and Freddie Mac to purchase subprime mortgages by allowing these mortgages to be counted toward the companies' requirements for affordable mortgage purchases.[45] In both instances, shortsighted policymakers either ignored or simply misunderstood the incentives their actions would create. Though presumably motivated by beneficent purposes, the catastrophic consequences of these actions call into question both the ability and the proper role of government in managing the financial sector.

It is important to note a contrast between the policies leading to the savings and loan collapse and those bringing about the crisis at Fannie Mae and Freddie Mac. The savings and loan collapse followed a series of ham-handed legislative decisions from the institution of Regulation Q to the passage of Garn-St Germain.[46] Agency decisions, by comparison, were largely responsible for the dangerous—and ultimately disastrous-- concentrations of subprime mortgages at Fannie Mae and Freddie Mac.[47] Though beyond the scope of this paper, this difference presents an interesting line of analysis.

C. Policy Rhetoric

The rhetoric surrounding the savings and loan bailout was much the same as that used in the Fannie Mae and Freddie Mac rescue. In the wake of the savings and loan crisis, the Financial Institutions Reform, Recovery, and Enforcement Act ("FIRREA") was passed to "safeguard and stabilize America's financial system."[48]

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[44] *See* H.R. REP. NO. 101-54(I), *supra* note 1, at 299, 95.
[45] *See* Leonnig, *supra* note 2.
[46] *See* H.R. REP. NO. 101-54(I), *supra* note 1.
[47] *See* Leonnig, *supra* note 2.
[48] Remarks on Signing the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, *supra* note 4.

The government explained its "commitment to protect the savings of . . . Americans" and claimed the reforms would ensure that such a crisis would "never happen again."[49] With the passage of FIRREA, Congress created the Resolution Trust Corporation ("RTC") to "contain, manage, and resolve failed savings associations"[50] and empowered it to "take warrants, voting and nonvoting equity, or other participation interests in resolved institutions."[51] The RTC was also to "foster home ownership opportunities for low- and moderate-income individuals."[52]

Sounding many of the same themes as officials twenty years prior, the Treasury Department sought to "provid[e] stability to financial markets" in its recent intervention to manage Fannie Mae and Freddie Mac.[53] The Federal Reserve Board echoed this sentiment, saying the action taken would "promote stability in our financial markets."[54] Accordingly, the Treasury Department announced a program to purchase Fannie Mae and Freddie Mac mortgage-backed securities to "broaden access to mortgage funding . . . [and] to promote market stability."[55] Additionally, the Treasury Department set terms and conditions under which a newly created Government Sponsored Entity Credit Facility would "ensure credit availability" to Fannie Mae and Freddie Mac.[56] The stated purpose of these terms was "to protect taxpayers."[57] The senior preferred stock purchase agreements between the government and Fannie Mae and Freddie Mac provided "significant protections for the taxpayer" in

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[49] *Id.*
[50] H.R. REP. NO. 101-54(I), *supra* note 1, at 322, 118.
[51] *Id.* at 357, 153.
[52] *Id.* at 309, 105.
[53] Henry M. Paulson, Jr., *supra* note 4.
[54] Press Release, Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., Statement (Sept. 7, 2008), *available at* http://www.federalreserve.gov/newsevents/press/other/20080907a.htm.
[55] Fact Sheet, U.S. Treasury Dep't Office of Pub. Affairs, GSE Mortgage Backed Sec. Purchase Program (Sept. 7, 2008), *available at* http://www.ustreas.gov/press/releases/reports/mbs_factsheet_090708hp1128.pdf.
[56] Fact Sheet, U.S. Treasury Dep't Office of Pub. Affairs, Gov't Sponsored Enter. Credit Facility (Sept. 7, 2008), *available at* http://www.ustreas.gov/press/releases/reports/gsecf_factsheet_090708.pdf.
[57] *Id.*

the form of government ownership of nearly eighty percent of each company.[58]

From these similarities, one understands that at a minimum, stated policy goals have remained consistent. Stable financial markets and the promotion of affordable housing continue to be key elements of the government's stated goals in its management of the financial sector. These laudable objectives are at least considered as politically useful today as two decades ago.

D. The Losers

In moving to rescue the savings and loan and mortgage lending industries, government actions have tended to harm arguably innocent actors.

1. Savings and Loan Industry Bailout

In the 1980s, the Federal Deposit Insurance Company (FDIC) made a practice of excluding claims by what it deemed to be less-deserving creditors.[59] Courts, however, defended creditors against this practice by invoking the National Bank Act.[60] The National Bank Act required "equal treatment" rights for creditors of a single class.[61] The government's plan to rescue the savings and loan industry, embodied in FIRREA, destroyed these "equal treatment" protections.[62] Under FIRREA, the FDIC could pay certain creditors less for their claims than paid to other creditors.[63]

Under FIRREA, commonly controlled insured financial institutions were forced to reimburse the FDIC, at the FDIC's request, for losses related to failure or assistance provided to such an institution.[64] This was referred to as a "cross-guarantee."[65] FIRREA

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[58] Fact Sheet, U.S. Treasury Dep't Office of Pub. Affairs, Treasury Senior Preferred Stock Purchase Agreement (Sept. 7, 2008) [hereinafter Treasury SPSPA Fact Sheet], *available at* http://ustreas.gov/press/releases/reports/pspa_factsheet_090708%20hp1128.pdf.
[59] Note, *Unsecured Creditors of Failed Banks: It's Not a Wonderful Life*, *supra* note 5, at 1052-53 (1991).
[60] *Id.* at 1053.
[61] *Id.*
[62] *Id.*
[63] *Id.*
[64] H.R. REP. NO. 101-54(I), *supra* note 1, at 325, 121.
[65] *Id.*

subordinated obligations and liabilities to other commonly controlled companies to these cross-guarantees,[66] but it did not stop there. Shareholders, including bank holding companies, thrifts, and shareholders and creditors of these institutions, had the obligations they held subordinated to the cross-guarantees.[67] Obligations subordinated to depositors as well as contingent claims met with the same fate.[68]

2. Fannie Mae and Freddie Mac Bailout

Under the terms of the Fannie Mae and Freddie Mac bailout, the Federal Housing Finance Agency ("FHFA") placed both companies in conservatorship.[69] The conservatorship, intended to place the companies on a firm financial footing, is indefinite.[70] Under such an arrangement, the companies' stockholders lose all powers except their rights to the financial value of their stock.[71] The value of the shares, however, faces even more uncertainty than usual.[72]

Damage to shareholders' financial stake in Fannie Mae and Freddie Mac can come in any of several ways. A capital injection would immediately dilute shares, though the long-term affect on share price is unclear.[73] While the companies are not immediately liquidated when placed under conservatorship, liquidation is not impossible.[74] Indeed, the Director of the FHFA has the authority to place the companies in receivership, the process for liquidation of a regulated enterprise.[75] In this scenario, the government may pay a nominal price for the shares or nothing at all.[76]

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[66] *Id.*
[67] *Id.*
[68] *Id.* at 325-26, 121-22.
[69] Henry M. Paulson, Jr., *supra* note 4.
[70] Fact Sheet, Fed. Hous. Fin. Agency, Questions and Answers on Conservatorship (Sept. 7, 2008) [hereinafter FHFA Fact Sheet], *available at* http://www.fhfa.gov/GetFile.aspx?FileID=35.
[71] *Id.*
[72] *See* Jessica Holzer, *Takeover May Help Homebuyers, Hit Fan-Fred Shareholders*, WALL ST. J. ONLINE, Sept. 6, 2008, http://online.wsj.com/article/SB122073569345807283.html.
[73] *Id.*
[74] FHFA Fact Sheet, *supra* note 70.
[75] *Id.*
[76] Holzer, *supra* note 72.

Shareholders were forced to face more than a stock price decline. As mentioned, under the terms of the Fannie Mae and Freddie Mac agreement, the government took ownership of nearly 80 percent of the companies through preferred stock purchases.[77] The agreement made this government preferred stock senior to both common and preferred shares of the companies, exposing shareholders to losses before the government.[78] Justifying this as "market discipline," Treasury Secretary Paulson conceded that the conservatorship arrangement placed "common shareholders last in terms of claims on the assets of the enterprise."[79]

Experts predicted that such a scheme would devastate share prices,[80] and such predictions proved correct. The Fannie Mae and Freddie Mac bailout was announced on Sunday, September 7, 2008.[81] Shares of Fannie Mae closed at $7.04 on September 5, 2008, the Friday prior to the Sunday announcement of the bailout.[82] Fannie Mae shares closed the following Monday at $0.73.[83] Similarly, Freddie Mac shares plunged from a closing price of $5.10 on Friday, September 5, to a closing price of $0.88 on Monday, September 8.[84]

3. Distinctions

One can draw important distinctions between the FIRREA fall-out and the harm done by the Fannie Mae and Freddie Mac bailout. Perhaps most striking is the receivership-conservatorship distinction. Receivership, the statutory process for liquidation,[85] was a major component of the legislative bailout of the savings and loan industry.[86] By contrast, under the conservatorship set up in the Fannie Mae and Freddie Mac bailouts, there is no intention of liquidation.[87] Also important to note is the scope of the bailout and consequent concentration of damage done to shareholders. FIRREA

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[77] Treasury SPSPA Fact Sheet, s*upra*, note 58.
[78] *Id*.
[79] Henry M. Paulson, Jr., *supra* note 4.
[80] *See* Holzer, *supra* note 72.
[81] *See, e.g.*, Henry M. Paulson, Jr., *supra* note 4.
[82] Google Finance Home Page, *supra* note 6.
[83] *Id.*
[84] *Id.*
[85] FHFA Fact Sheet, *supra* note 70.
[86] *See, e.g.*, H.R. REP. NO. 101-54(I), *supra* note 1, at 355, 151.
[87] FHFA Fact Sheet, *supra* note 70.

addressed the concerns of hundreds of failing or failed thrifts across the nation.[88] The Fannie Mae and Freddie Mac bailouts are, of course, directed at only these two companies, with the accompanying share price dilution affecting its shareholders directly.[89] While both bailouts left many in bad shape, there are important distinctions to be considered.

E. Conclusion

The crisis that today faces the mortgage giants Fannie Mae and Freddie Mac is different in scope and substance from the problems faced by the savings and loan industry in the 1980s. Accordingly, the structure of the government's response to the situation at Fannie Mae and Freddie Mac differed from its response to the savings and loan failures. However, the two episodes are far from unrelated.

In the Fannie Mae and Freddie Mac debacle as well as the savings and loan collapse, industries reacted to government policy and regulation in rational ways. These policies and regulations, however, pushed the private actors into trouble. The legislative actions leading to the savings and loan crisis of the 1980s parallel the policy and regulatory actions that drove Fannie Mae and Freddie Mac into harm's way. When it became clear that the savings and loan industry would need to be rescued, politicians justified the measures they took with a rhetorical flourish echoed by today's leaders as they work to prevent Fannie Mae and Freddie Mac from collapsing. Finally, and unfortunately, the savings and loan and Fannie Mae and Freddie Mac bailouts left many innocent victims in their wakes. Whether it was unsecured creditors in the 1980s or shareholders today, government bailout schemes chose small investors to bear unfair burdens.

The federal government's institutional memory in financial sector regulation appears exceedingly short. The government would do well to take lessons from the not-so-distant past before plunging the next industry into ruin.

Aaron Withrow[90]

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[88] H.R. REP. NO. 101-54(I), *supra* note 1, at 308, 104.
[89] *See* Henry M. Paulson, Jr., *supra* note 4.
[90] Student, Boston University School of Law (J.D. 2010).

V. The Collapse and Rescue of Bear Stearns

A. Introduction

On May 29, 2008, the shareholders of Bear Stearns ("Bear") formally approved a sale of the company to JP Morgan Chase ("JPM") for $10 a share, capping a tumultuous and devastating year for Bear.[1] In the blink of an eye, an eighty-five-year-old company, which was the fifth largest investment bank on Wall Street,[2] ceased to exist as an independent entity. This article will trace the rise and fall of what was once one of the most profitable and respected investment banks in the world. First, it will provide a brief overview of the storied history of Bear. It will then explore the business decisions and market dynamics that precipitated Bear's sudden collapse. It examines the process by which Bear was saved from insolvency and acquired by JPM, as well as discusses the financial, political, and regulatory implications associated with Bear's collapse and rescue. The article then explores the reaction by industry experts and commentators to the collapse and rescue. Lastly, it looks at the uncertain future of the remnants of Bear.

B. History of Bear Stearns

Bear was founded in 1923 with $500,000 in capital and quickly became a leader in trading government securities.[3] Despite the 1929 stock market crash, the company survived without laying off any of its employees.[4] The firm opened its international department in 1948 and its first international office in Amsterdam in 1955.[5] In the 1950's the company became one of the originators of

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[1] Gerald Magpily & Carolyn Murphy, *Dealwatch: J.P. Morgan-Bear Stearns Merger*, THEDEAL.COM, June 5, 2008, http://www.thedeal.com/dealscape/2008/06/dealwatch_bear_stearns.php.

[2] *Stripped Bear: Bear Stearns*, ECONOMIST.COM, Mar. 14, 2008, *available at* http://www.economist.com/displayStory.cfm?story_id=10870166&fsrc=RRS.

[3] Bear Stearns Companies, Inc.: Company History, http://www.fundinguniverse.com/company-histories/Bear-Stearns-Companies-Inc-Company-History.html (last visited Oct. 8, 2008).

[4] *A History of Bear Stearns*, N.Y. TIMES, Mar. 17, 2008, at A16, *available at* http://www.nytimes.com/imagepages/2008/03/17/business/20080317_BEAR_STEARNS_GRAPHIC.html (last visited Oct. 8, 2008).

[5] Bear Stearns Companies, Inc.: Company History, *supra* note 3.

block trading and continued to expand its retail business operations in the late 1960's.[6] By the time Bear became a publicly traded company in 1985, it had $517 million in total capital.[7] The company saw its earning skyrocket in the 1990's and emerged by 2000 as one of the few remaining large independent financial services firms in the country.[8]

C. Lead-up to Failure

Subprime borrowers are borrowers who have poor credit ratings, making them higher risks for default.[9] Between 2004 and 2007, home mortgage lenders lent tens of billions of dollars to subprime borrowers in potentially high-interest mortgage debt.[10] In fact, about six million subprime borrowers borrowed about 100 percent of the value of their homes at the peak of the housing market.[11] The mortgage lenders quickly packaged these mortgages into bonds called mortgage-backed securities ("MBSs"), which were then sold to other financial organizations such as Bear.[12] While the mortgage lenders then had cash to be used for new mortgage loans to subprime borrowers, Bear and other investment banks sliced the MBS packages into "tranches" known as Collateralized Debt Obligations ("CDOs").[13] These CDO tranches were split into high risk "equity" bonds, middle risk "mezzanine" bonds, and low risk "investment grade" bonds.[14] Bear sought to sell these CDO tranches in the secondary market, and the investment grade bonds proved easy

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[6] *Id.*
[7] *Id.*
[8] *Id.*
[9] *See generally Developments in Banking and Financial Law—The Subprime Mortgage Crisis*, 27 REV. BANKING AND FIN. L. 1 (2008).
[10] Editorial, *Regulation to the Rescue; While the Fed Tries to Stabilize the Financial System, Measures are Needed to Prevent Mortgage Market Abuses*, WASH. POST, Mar. 16, 2008, at B06.
[11] Paul Tustain, *Subprime Mortgage Collapse: Why Bear Stearns is Just the Start*, MONEYWEEK.COM, Mar. 18, 2008, http://www.moneyweek.com/investment-advice/how-to-invest/subprime-mortgage-collapse-why-bear-stearns-is-just-the-start.aspx.
[12] *Id.*
[13] David Leonhardt, *Can't Grasp Credit Crisis? Join the Club*, N.Y. TIMES, Mar. 19, 2008, at A1.
[14] Tustain, *supra* note 11.

to sell.[15] This was significant, as the government-sanctioned credit rating agency oligopoly[16] had rated more than 80 percent of subprime mortgages as AAA debts.[17] However, equity and mezzanine bonds were harder to sell, and investment banks used a variety of methods to accomplish this goal.[18] One method was to set up hedge funds that would buy the equity and mezzanine bonds, and Bear indeed set up two hedge funds for such purpose.[19] The hedge funds used the CDOs as collateral to borrow from lending banks, which gave them more cash to buy more CDOs from Bear.[20] The loose monetary policies of the Federal Reserve ("Fed") helped to provide liquidity in the market for these loans, especially with regard to the spread between the Federal Funds rate and real inflation, amounting to a substantial government subsidy for risky debt.[21] Another method was to transfer the risk of default in a package of CDOs to an underwriter in a credit default swap ("CDS").[22] In exchange for the underwriter taking on the risk of default on the CDOs, Bear would pay the underwriter an insurance premium.[23] Last, Bear would sell much of its higher risk CDOs to investment funds and other institutional investors like Fannie Mae and Freddie Mac.[24] In fact, because of their rampant purchase of toxic mortgages from Bear and other investment banks in the name of expanding access to "affordable housing," these government-sponsored enterprises ("GSEs") eventually had a total

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[15] *See id.*

[16] *See* Opinion, *A Mortgage Fable*, WALL ST. J., Sept. 22, 2008, at A22.

[17] Charles W. Calomiris, *The Subprime Turmoil: What's Old, What's New, and What's Next*, VOX, Aug. 22, 2008, http://www.voxeu.org/index.php?q=node/1561.

[18] Tustain, *supra* note 11.

[19] *Id.*

[20] *See* Justin Fox, *The Bear Trap*, TIME, Mar. 31, 2008, at 32, *available at* http://www.time.com/time/magazine/article/0,9171,1724381,00.html.

[21] *See Systemic Risk and the Financial Markets: Hearing Before the H. Fin. Serv. Comm.*, 110th Cong. 18-19 (2008) (statement of Rep. Ron Paul, Member, H. Fin. Serv. Comm.).

[22] *See* Eric Petroff, *Who is to Blame for the Subprime Crisis?*, INVESTOPEDIA.COM, http://www.investopedia.com/articles/07/subprime-blame.asp?Page=4.

[23] *See* Tustain, *supra* note 11.

[24] *See* Charles W. Calomiris & Peter J. Wallison, Opinion, *Blame Fannie Mae and Congress for the Credit Mess*, WALL ST. J., Sept. 23, 2008, at A29.

exposure to subprime and slightly less risky Alt-A mortgages exceeding $1 trillion.[25]

To fuel its hyper-investment in MBSs, Bear borrowed large amounts of money—it took out nearly $34 in loans for every dollar of equity.[26] Likewise, its hedge funds were leveraged at 5:1 and 15:1 ratios, respectively.[27] Furthermore, Bear was more exposed to mortgage markets and less diversified than competing investment banks.[28] When the housing market collapsed, the value of MBSs, and consequently their value as collateral, plummeted, and as a result they became unmarketable.[29] Consequently, two of Bear's hedge funds collapsed,[30] likely because creditors demanded additional collateral for their MBS-backed loans. Other financial institutions began refusing to engage in CDSs with Bear,[31] its CDOs became unmarketable, and credit markets froze.[32] Because like all investment banks Bear was especially reliant on short-term funding, these events created a severe liquidity crisis for the company.[33] As rumors of a cash crisis swirled, investors began pulling their cash out of Bear by the billions, quickly depleting its $17 billion in reserves.[34] Additionally, its stock price declined by a remarkable fifty percent in one day.[35] Soon, it became clear that Bear was teetering on the brink of insolvency.[36]

D. Process of Rescue

Facing Bear's possible insolvency, the Fed agreed to provide emergency funding to the company through its discount window on Friday, March 14, 2008.[37] Using JPM as a conduit due to its status as a depository institution, the Fed allowed Bear to post mortgage assets

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[25] *See id.*
[26] Patrice Hill, *Fed Rescues Bear Stearns*, WASH. TIMES, Mar. 15, 2008, at A01.
[27] Tustain, *supra* note 11.
[28] *Stripped Bear; Bear Stearns*, *supra* note 2.
[29] Editorial, *Regulation to the Rescue*, *supra* note 10.
[30] *Stripped Bear; Bear Stearns*, *supra* note 2.
[31] *See id.*
[32] Editorial, *Regulation to the Rescue*, *supra* note 10.
[33] *See Stripped Bear; Bear Stearns*, *supra* note 2.
[34] Hill, *supra* note 26.
[35] *See Stripped Bear; Bear Stearns*, *supra* note 2.
[36] Hill, *supra* note 26.
[37] *Stripped Bear; Bear Stearns*, *supra* note 2.

as collateral in exchange for twenty-eight-day loans to keep it solvent.[38] By Monday, March 17, the Fed had brokered a deal under which JPM agreed to purchase Bear for $236 million at $2 per share, which was about one percent of its market value in January of 2008.[39] However, Bear's employees and shareholders immediately protested this arrangement and threatened to block the deal.[40] As a result, on March 24, JPM raised its offer to $10 per share and offered amendments to other parts of the deal.[41] The Fed agreed to give JPM a $29 billion line of credit at the discount interest rate in exchange for $30 billion in Bear's most toxic assets as collateral.[42] JPM was not required to repay this loan, as the Fed was to begin selling off the mortgages before it was repaid.[43] Instead, the Fed would keep the profits should the proceeds from the mortgage sales yield more than $30 billion, and would absorb all but $1 billion of the losses should the sales generate any less.[44] On May 29, Bear's shareholders formally approved the sale to JPM.[45]

E. Implications of the Rescue

There have been a number of financial, political, and regulatory implications associated with the collapse and rescue of Bear.[46] The Fed has opened its discount window, normally reserved for commercial banks, to investment banks.[47] In fact, Fed Chairman

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[38] *Id.*
[39] *Bear Stearns Rescued by JP Morgan and Fed*, BANKING NEWSLINK, Mar. 18, 2008.
[40] *See JP Morgan Chase's Struggle With Bear Stearns*, ECONOMIST, Mar. 29, 2008, *available at* http://www.economist.com/finance/displaystory.cfm?story_id=10926298.
[41] *Id.*
[42] David Freddoso, *Bear With Me*, NAT'L REV ONLINE., Apr. 2, 2008, *available at* http://author.nationalreview.com/?q=MjY4Nw== (author archive; follow title hyperlink under "April 2008"heading).
[43] *Id.*
[44] *Id.*
[45] Magpily & Murphy, *supra* note 1.
[46] *See generally* Patrice Hill, *Senate Probes Bailout by Fed; Regulation Posed for Firms*, WASH. TIMES, Mar. 27, 2008, at A01; Interview by Charlie Rose with Jamie Dimon, CEO, JP Morgan Chase, on *The Charlie Rose Show* (Public Broadcasting Station broadcast July 7, 2008).
[47] Diana Furchtgott-Roth, *Bear Stearns Better Than U.K. Bailout*, N.Y. SUN, Mar. 19, 2008, at 9.

Ben Bernanke has suggested that the Fed might need to keep the window open until 2009 to stabilize the financial markets and prevent liquidity problems from dooming other major investment banks.[48] Treasury Secretary Henry Paulson has stated that access by investment banks to potential taxpayer funds might need to be accompanied by the stricter regulatory standards to which commercial banks are subjected.[49] Chairman Bernanke has also asked for the Fed to be given more power to regulate investment banks, specifically with regard to the complex financial instruments they create.[50] Additionally, Chairman Bernanke has called for congress to pass laws that will allow regulators to close down and liquidate investment banks when they fail, as the Federal Deposit Insurance Corporation ("FDIC") is currently empowered to do with commercial banks.[51] The significance of these potential regulatory developments may be lessened by the likelihood that most standalone investment banks will become affiliated with depository institutions in the future to take advantage of their substantial capital reserves.[52]

The fact that taxpayers are at risk for losing billions of dollars in the Bear rescue has prompted politicians to probe the Fed's role in the bailout.[53] Moreover, President-elect Barack Obama has called for more regulation in the form of stricter capital requirements, transparency requirements, and regulations against conflicts of interest for investment banks.[54] He and other politicians have pointed to "deregulation" as the prime culprit for the financial crisis underlying Bear's collapse, despite the fact that there has been no significant deregulation in the financial sector during the last thirty years,[55] and despite the compelling arguments that government fiscal, monetary, and regulatory policy have both helped create and exacerbate the subprime lending crisis.[56]

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[48] *See* Patrice Hill, *Bernanke Calls for New Fed Power*, WASH. TIMES, July 9, 2008, at A10.
[49] Hill, *supra* note 46.
[50] Hill, *supra* note 48.
[51] *Id.*
[52] *See* Calomiris, *supra* note 17.
[53] Hill, *supra* note 46.
[54] Robert Kuttner, Op-Ed., *Regulating the Free-Market Free Fall*, BOSTON GLOBE, Apr. 3, 2008, at A11.
[55] Peter J. Wallison, *Obama Voted 'Present' on Mortgage Reform*, WALL ST. J., Oct. 15, 2008, at A19.
[56] *See generally* Calomiris, *supra* note 17; Russell Roberts, *How Government Stoked the Mania*, WALL ST. J., Oct. 3, 2008 at A21.

F. Reaction to the Rescue

Reaction to the collapse and rescue of Bear has been mostly that of alarm and outrage.[57] Lawsuits and arbitration requests have been filed on behalf of shareholders against Bear for fraud, breach of fiduciary duty, omitting material facts, and issuing false and misleading statements.[58] Liquidators of Bear's defunct hedge funds have also filed suit against Bear for fraud, breach of contract, and gross negligence.[59] Additionally, federal criminal charges have been brought against two of Bear's hedge fund managers for conspiracy, securities fraud, and wire fraud.[60]

Commentators and industry experts disagree on the long-term effects of the Fed's intervention in Bear's collapse and rescue. The main argument of those in favor of the Fed's intervention argue that it prevented what could have turned into a meltdown of the whole financial system.[61] Furthermore, some have questioned whether the bailout will cost taxpayers any money at all, noting that in the ten year repayment period the value of the assets taken on by the Fed may rebound, perhaps even leading to a profit.[62]

Those opposed to the intervention bring forth numerous arguments. One argument is that capitalism is a profit and loss system.[63] People take risks because there is a potential for profit, but to encourage prudence in risk-taking there also must be a potential for loss.[64] If an agency bails out people who make bad decisions, it

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[57] *See generally, e.g.*, *Developments in Banking and Financial Law*, *supra* note 9; *Fed Trying to Revive Alcoholic with Whisky*, MONEY MARKETING, June 12, 2008, at 7.

[58] *See* Thomas S. Mulligan & Tom Petruno, *Lawsuit Accuses Bear of Fraud*, L.A. TIMES, Apr. 12, 2008, at C3; *Mark & Associates, P.C. File Arbitration on Behalf of Bear Stearns Shareholders,* PRIME NEWSWIRE, May 27, 2008, *available at* http://www.istockanalyst.com/article/viewarticle+articleid_1967136.html.

[59] *See Another Bear Stearns Lawsuit*, NEWSINFERNO.COM, Apr. 9, 2008, http://www.newsinferno.com/archives/2876.

[60] Dan McLean, *Vermonter Indicted*, BURLINGTON FREE PRESS, June 20, 2008, at 1A.

[61] *See, e.g.*, Hill, *supra* note 26; Hill, *supra* note 48.

[62] *See* Hill, *supra* note 48.

[63] *See* Interview by Robert Siegel with Russell Roberts, Economist, George Mason University, on *National Public Radio* (Mar. 25, 2008).

[64] *See id.*

merely encourage more irresponsibility and bad decision making in the future.[65] Furthermore, some argue that it is hypocritical for those on Wall Street to strongly support laissez-faire capitalism when times are good, but ask for government intervention and rescue when their livelihoods are threatened.[66] Another argument is that the Fed's actions amount to a "covert partial [nationalization] of the banking system."[67] While the United States has often accused foreign sovereign wealth funds and central banks of intervening in currency exchange markets, distorting capital flows, and practicing "state capitalism," the Fed's intervention is a prime example of direct interference with market mechanisms.[68] Last, there is an argument that the Fed has created a "moral hazard" by making taxpayers bear the brunt of the irresponsible decisions made by those in the financial industry in connection with their past excesses.[69] To take tax money from people who have made responsible decisions and give it to those who have not is unfair and may create perverse incentives.[70] Overall, the ultimate tradeoff of the Fed's intervention in Bear's collapse may be the avoidance of a current painful market correction in exchange for the possible distortion of market mechanisms and economic incentives that could precipitate another financial disaster in the future.

G. Future of Bear Stearns

The remnants of Bear have an uncertain future. JPM has pledged to continue to use the Bear name and to keep Bear brokers separate from its own.[71] However, as is the case with many high profile mergers, the clash of corporate cultures may prove a challenge.[72] While many Bear employees will lose their jobs, others

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[65] *See id.*
[66] *See* Jeff Pantages, *With Wall Street, Relationships Call for Skepticism, Not Faith*, PENSIONS AND INVESTMENTS, Apr. 14, 2008, at 12.
[67] *Fed Trying to Revive Alcoholic with Whisky*, *supra* note 57.
[68] *See generally State Capitalism and the U.S.*, GULF NEWS, Mar. 29, 2008.
[69] *See* Andrew Clare, *Bear Necessities*, FIN. ADVISER, Mar. 27, 2008.
[70] Hal Heaton, *'Moral Hazard' Sometimes Makes Economic Problems Worse*, DESERET MORNING NEWS, Apr. 13, 2008.
[71] Liz Wolgemuth, *JP Morgan and Bear Stearns: A Culture Challenge*, U.S. NEWS & WORLD REP., Mar. 31, 2008, *available at* http://www.usnews .com/articles/business/careers/2008/03/31/jpmorgan-and-bear-stearns-a-culture-challenge .html.
[72] *Id.*

have been offered retention bonuses to stay at the firm.[73] With regard to Bear's many subsidiaries, some will be spun off into wholly independent entities,[74] while others will be retained and integrated into JPM's business structure.[75] As a whole, it appears that while the Bear name will live on in some capacity, its eighty-five-year-old identity will cease to exist.

H. Conclusion

Bearn Stearns had a long and storied history as one of the most successful investment banks on Wall Street. However, from 2004 to 2007 it took enormous risks in the mortgage market in hopes of tapping into its robust and unprecedented growth and profitability.[76] Bear's highly leveraged gambling on MBSs, CDOs, and CDSs, with the expectation of asset appreciation, proved disastrous.[77] When the housing market collapsed, Bear faced a severe liquidity crisis due to the collapse of its hedge funds,[78] a lack of willing creditors,[79] and investor panic.[80] Facing Bear's imminent insolvency, the Fed quickly intervened, first arranging access by Bear to its discount window[81] and later brokering a deal under which Bear would be acquired by JPM for the eventual price of $10 per share.[82] Because of the collapse and rescue, the Fed has opened its discount window to investment banks, which may eventually be accompanied by stricter regulation.[83] Politicians have called for a range of new regulations including stricter capital requirements, transparency requirements, and regulations against conflicts of interest for investment banks,[84] despite the evidence that government intervention into the market has contributed to the subprime crisis.[85]

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[73] *Id.*
[74] *See* Magpily & Murphy, *supra* note 1.
[75] *See generally* Martin Arnold, *Bear Buy-Out Arm Stays Course*, FIN. TIMES, Sep. 7, 2008, at 24.
[76] *See generally* Tustain, *supra* note 11.
[77] *See generally id.*
[78] *See Stripped Bear; Bear Stearns*, *supra* note 2.
[79] *See* Editorial, *Regulation to the Rescue*, *supra* note 10.
[80] *See generally* Hill, *supra* note 26.
[81] *Stripped Bear; Bear Stearns*, *supra* note 2.
[82] *See JP Morgan Chase's Struggle With Bear Stearns*, *supra* note 40.
[83] *See* Hill, *supra* note 46.
[84] *See* Kuttner, *supra* note 54.
[85] *See generally* Calomiris, *supra* note 17.

Commentators and industry experts have disagreed on the long-term ramifications of the Fed's intervention. While many argue that the bailout was necessary to save the entire financial system from a meltdown,[86] others argue that the intervention will create perverse market incentives,[87] usher in a regime of "state capitalism" in the United States,[88] and create "moral hazard" by making taxpayers pay for the fallout of irresponsible decision making by those in the financial industry.[89] Ultimately, there may be a tradeoff between averting a current crisis and fostering a systemic long-term market distortion. Bear's uncertain future likely includes job layoffs,[90] restructuring,[91] and a potential clash of corporate cultures.[92] What is certain, however, is that while the collapse and rescue of Bear Stearns extinguishes the unique identity of one of the most recognizable firms on Wall Street, its effects will reverberate long into the future.

Ian Boardman[93]

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[86] *See, e.g.*, Hill, *supra* note 26; Hill, *supra* note 48.
[87] *See* Interview by Robert Siegel with Russell Roberts, *supra* note 63.
[88] *See generally State Capitalism and the U.S.*, *supra* note 68.
[89] *See* Clare, *supra* note 69.
[90] *See* Wolgemuth, *supra* note 71.
[91] *See generally* Arnold, *supra* note 75.
[92] *See* Wolgemuth, *supra* note 71.
[93] Student, Boston University School of Law (J.D. 2010)

VI. Investment Bank Regulation and the Credit Crisis

A. Introduction

Investment banks have been greatly affected by the current financial crisis, from the failure of Lehman Brothers, to the sale of Merrill Lynch, and the conversion of Morgan Stanley and Goldman Sachs into bank holding companies.[1] This situation poses the question, how can the current regulatory system be revised in order to better protect against a crisis like this in the future? Despite the failure, sale, or conversion of the five major independent investment banks, investment banking as an industry and a business model continues today.[2] The issue of proper investment banking regulation is not merely academic but has a real and urgent importance in the current financial system. First, this paper will look at the system of investment banking regulation leading up to the current crisis. Next, it will examine why reform of the U.S. regulatory structure is necessary. Finally, it will examine and analyze the various proposals to revise investment bank regulation.

B. Investment Bank Regulation Leading Up To Crisis

Gaining an understanding of the current financial regulatory system requires an examination of the legislation that underlies it. In 1933, the United States Congress passed the Glass-Steagall Act, which separated investment banks from commercial banks.[3] However, Congress passed the Gramm-Leach-Bliley Act in 1999, which removed the separations of commercial banks and investment banks and allowed commercial banks to include investment banking operations in their holding company umbrella.[4] These banks can

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[1] Vikas Bajaj et al., *Radical Shift For Goldman And Morgan*, N.Y. TIMES, Sept. 21, 2008, at A; *see also* Roy C. Smith & Ingo Walter, *Is This The End of 'Americanized Finance'?*, FORBES.COM, Oct. 7, 2008, *available at* http://www.forbes.com/opinions/2008/10/06/basel-americanized-european-oped-cx_rs_1007smith.html.

[2] Philip Augar, *Do Not Exaggerate Investment Banking's Death,* FIN. TIMES, *available at* http://us.ft.com/ftgateway/superpage.ft?news_id=fto092220081459391863.

[3] Bajaj, *supra* note 1.

[4] *See generally* Smith, *supra* note 1.

engage in the functions of investment banks while also accepting deposits, which traditional investment banks cannot do.[5]

The Federal Reserve is responsible for regulating financial holding companies, bank holding companies, and certain state-chartered banks.[6] When this credit crisis began, the Federal Reserve did not have the power to monitor investment banks because investment banks are not deposit taking institutions.[7] Instead, the regulation of investment banks was left to the Securities and Exchange Commission ("SEC").[8] The SEC only had the statutory authority to monitor the brokerage activities of investment banks, however, and it did not have the power to monitor the investment banks by regulating the investment bank holding companies.[9]

In 2004, recognizing this gap in regulation, the SEC created a voluntary regulation program called the Consolidated Supervised Entity Program ("CSE").[10] Despite the program's good intentions, it was fraught with problems from its inception.[11] Investment banks themselves pushed for this regulation. in response to threats by the European Union ("EU") to impose its own regulations on the foreign subsidiaries of American investment banks if those banks were not already subject to similar oversight in America.[12] Seeking to escape onerous regulation by the EU, American investment banks successfully lobbied the SEC to begin the CSE program.[13] The CSE program has turned out to be an abysmal failure, and has been acknowledged as such by Christopher Cox, Chairman of the SEC.[14] Chairman Cox noted, "[the program] was fundamentally flawed from the beginning, because investment banks could opt in or out of

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[5] *See generally* Smith, *supra* note 1.

[6] Fact Sheet, U.S. Dep't of the Treasury, Treasury Releases Blueprint for a Stronger Regulatory Structure, http://www.ustreas.gov/press/releases/reports/Fact_Sheet_03.31.08.pdf.

[7] *Id.*

[8] Stephen Labaton, *S.E.C. Concedes Oversight Flaws Fueled Collapse*, N.Y. TIMES, Sept. 27, 2008, at A1; Mark Pittman et al., *Cox's SEC Censors Report on Bear Stearns Collapse*, BLOOMBERG, Oct. 8, 2008, *available at* http://bloomberg.com/apps/news?pid=20601109&refer=home&sid=a6iXuZJG1L44.

[9] Labaton, *supra* note 8.

[10] *Id.*

[11] *Id.*

[12] *Id.*

[13] *Id.*

[14] *Id.*

supervision voluntarily. The fact that investment bank holding companies could withdraw from this voluntary supervision at their discretion diminished the perceived mandate [of the program and] weakened its effectiveness."[15]

Recently, the Federal Reserve has taken a much more prominent role in regulating aspects of the financial system. Under a framework established in October 2008, many of the SEC's oversight responsibilities will shift to the Federal Reserve.[16] The Federal Reserve and the SEC issued a Memorandum of Understanding ("MOU") on July 7, 2008, outlining a new system of information sharing and cooperation between the two agencies, which will cover "Consolidated Supervised Entities", i.e. investment banks.[17] This agreement "formalizes the long-standing cooperative arrangements between the SEC and the Board, as well as the more recent cooperation on matters including banking and investment banking capital liquidity."[18] According to the MOU, this agreement will help the SEC act as supervisor and improve the ability of the Federal Reserve to act as overseer of the stability of the financial system.[19] Despite these efforts, many people recognize that a fundamental flaw exists in US financial regulation. This flaw is due to what Treasury Secretary Henry Paulson referred to as the "balkanized" system of financial regulation, wherein regulatory responsibilities are often fragmented and disjointed because of an anachronistic regulatory structure.[20]

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[15] *Id.*

[16] Labaton, *supra* note 8.

[17] Kim Dixon & Rachelle Younglai, *SEC Finds Voice with Investment Bank Plan*, REUTERS, July 28, 2008, *available at* http://www.reuters.com/article/reutersEdge/idUSN2746039420080728.

[18] Memorandum of Understanding Between the U.S. Securities and Exchange Commission and The Board of Governors of the Federal Reserve System Regarding Coordination and Information Sharing in Areas of Common Regulatory and Supervisory Interest (July 7, 2008), http://www.sec.gov/news/ press/2008/2008-134_mou.pdf.

[19] *Id.*

[20] Remarks by Henry M. Paulson, Jr., U.S. Sec'y of the Treasury, on the U.S., the World Economy and Markets before the Chatham House (July 2, 2008), *available at* http://www.ustreas.gov/press/releases/hp1064.htm.

C. The Need for Regulatory Reform

1. Why Regulatory Reform is Necessary

All sides seem to agree that the current system of financial regulation is antiquated and the remnant of financial conditions that bear little resemblance to the ones that exist today. SEC Chairman Christopher Cox and Timothy Geithner, president of the Federal Reserve Bank of New York, echoed this sentiment when they testified before Congress in July.[21] Both agreed that the current regulatory structure overlapped at times while at other times it left areas unregulated, partially contributing to the current financial meltdown.[22] Treasury Secretary Henry Paulson has pushed for a more modern approach to regulation leading to the creation of the *Blueprint for a Modernized Regulatory Structure* ("*Blueprint*").[23] The *Blueprint* notes that the current structure of regulation was strung together over 75 years with little to no strategic focus.[24] It also notes that, for the most part, the underlying regulatory structure of the US financial system resembles what existed in the 1930s.[25]

2. The Treasury Department's Blueprint for a Modernized Financial Regulatory Structure

The Treasury's *Blueprint* offers changes to the financial regulatory structure in the short and intermediate term, as well as advocates an "objectives-based" approach to financial regulation.[26] In the short term, the proposal seeks to improve regulatory coordination and oversight. One way the Treasury seeks to accomplish this is through the President's Working Group ("PWG"),

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[21] Joshua Zumbrun, *A Single Bank Regulator*, FORBES.COM, *available at* http://www.forbes.com/2008/07/24/banks-subprime-sec-biz-cx_jz_0725 regulator.html.
[22] *Id.*
[23] DEP'T OF THE TREASURY, BLUEPRINT FOR MODERNIZED FINANCIAL REGULATORY STRUCTURE (2008); *see also* Remarks by U.S. Treasury Secretary Henry M. Paulson, Jr., *supra* note 20.
[24] Fact Sheet, *supra* note 6.
[25] *Id.*
[26] *Id.; see also* Cheyenne Hopkins, *Treasury Proposal Would Combine Federal Bank, Thrift, Credit Union Charters*, AM. BANKER, *available at* http://www.americanbanker.com/article.html?id=20080329R7E923KX.

which is a powerful tool for interagency coordination in the regulation of financial services.[27] The Treasury wants to modernize the PWG and focus it on matters such as systemic risk, investor and consumer protection, and market integrity.[28] The Treasury also wants to expand access to Federal Reserve lending channels, make such lending more transparent, and give the Federal Reserve access to information on non-depository institutions (such as investment banks) which are granted access to Federal Reserve loans.[29] How to gather this information would ultimately be determined by the Federal Reserve, but one possible method includes on-site examination.[30]

In the intermediate term, the Treasury's proposes to eliminate duplication within the US's financial regulatory structure and to modernize it.[31] In essence, the *Blueprint* calls for the merger of several regulatory agencies to reduce duplicative efforts and the addition of federal oversight in the area of insurance.[32] In the longer term, the Treasury seeks to develop an objectives-based approach to regulation around the important goals of market stability, safety and soundness, and business conduct.

The *Blueprint* advocates changing the role of the Federal Reserve. The traditional role of the Federal Reserve limits its power to acting as supervisor of financial holding companies, bank holding companies, and certain state-chartered banks.[33] Under the *Blueprint*, the Federal Reserve would take on the responsibility to "gather appropriate information, disclose information, collaborate with other regulators on rule writing, and take corrective actions when necessary to ensure the overall financial market stability."[34] Through these changes in power, the Federal Reserve would have the ability to monitor risk across the financial system.[35] This proposal would give the Federal Reserve the power to regulate institutions such as

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[27] Fact Sheet, *supra* note 6.
[28] *Id.*
[29] *Id.*
[30] *Id.*
[31] *Id.*
[32] *Id.*
[33] *Id.*
[34] *Id.*
[35] Edmund L. Andrews, *Treasury's Plan Would Give Fed Wide New Power*, N.Y. TIMES, at A1.

investment banks if they posed a systemic threat to the U.S. financial system.[36]

The *Blueprint* also suggests having a single prudential regulator to focus on the safety and soundness of firms with federal guarantees.[37] In most instances, however, this change would not impact the regulation of investment banks.

Finally, the Treasury seeks to create a single business conduct regulator to "monitor business conduct regulation across all types of financial firms."[38] This would include consumer protection, writing rules for disclosure, and setting rules for business practices.[39]

D. Paulson Defends Treasury Proposal

Secretary Paulson has defended the Treasury's vision for a modernized U.S. financial regulatory structure since its proposal. During a speech he gave in London in July 2008, Paulson acknowledged that few regard the current regulatory system as optimal[40] and that the current US system is outdated.[41] He stated that, "Our goal… is to modernize the U.S. financial regulatory structure to better reflect modern financial markets."[42] Secretary Paulson noted that while the Federal Reserve is expected to act in situations that present a systemic risk to the financial markets, it does not have the statutory authority or mandate to prevent systemic risks from spreading.[43] In response to this, Paulson noted that the *Blueprint* expanded the Federal Reserve's power to protect the financial system from systemic risks.

Paulson also acknowledged a major concern in any regulatory reform: market discipline.[44] If companies can expect a bailout every time they make risky decisions that fail, they have an incentive to take unwise risks because they reap the profits on the

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[36] *Id.*
[37] Fact Sheet*, supra* note 6.
[38] *Id.*
[39] *Id.*
[40] Remarks by U.S. Treasury Secretary Henry M. Paulson, Jr., *supra* note 20.
[41] *Id.*
[42] *Id.*
[43] *Id.*
[44] *Id.*

upside and will be bailed out on the downside.[45] A commentator recently referred to this as "a system where profits are privatized and . . . losses socialized." [46] In response to this concern, Paulson noted, "In an optimal system, market discipline effectively constrains risk because the regulatory structure is strong enough that a financial institution can fail without threatening the overall system[; f]or market discipline to constrain risk effectively, financial institutions must be allowed to fail."[47] Paulson advocates giving emergency authorization to regulators in the event of a large complex financial firm collapsing.[48] Paulson notes that, in order to reinforce market discipline, costs should be imposed upon creditors and equity holders so that while the institution may be allowed to fail in an orderly manner, stakeholders in the enterprise will lose their investments and therefore market discipline will continue to exist.[49]

E. Thoughts on the Regulatory Proposals

1. In Favor of the Treasury Proposal

Most people concede that changes in the regulatory structure should take place, but there is disagreement on the form that these revisions should take. On one side, there are those who advocate the *Blueprint*. They claim that streamlining the regulatory structure, eliminating areas of overlap and redundancy, and eliminating gaps in regulation will protect against problems in the future.[50] These advocates believe that if the Federal Reserve were given the power to demand information and order changes in investment bank policies to guard against risk and failure, the system would be adequately protected from such failures in the future.[51]

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[45] *Id*.

[46] Emily Kaiser, *After AIG Rescue, Fed May Find More At Its Door,* REUTERS, Sept. 17, 2008, *available at* http://www.reuters.com/article/idUKN1644235820080917.

[47] Remarks by U.S. Treasury Secretary Henry M. Paulson, Jr., *supra* note 20.

[48] *Id*.

[49] Christopher Rugaber, *Pressure Rising for Tighter Regulation of Insurance, Financial Services*, INS. J., Oct. 7, 2008, *available at* http://www.insurancejournal.com/news/national/2008/10/07/94401.htm.

[50] *Id.*

[51] *Id.*

2. Other Visions for Reform

However, others advocate for a different type of regulatory reform. Barney Frank, Chairman of the House Financial Services Committee, and other senior Democrats propose regulating investment banks similarly to commercial banks.[52] To begin to understand this proposal, it is important to first examine the ways commercial banks and investment banks previously operated.

First, different types of institutions are allowed to assume very different levels of debt. A firm's debt-to-equity ratio shows the amount of money an institution has borrowed in relation to the amount of capital it holds.[53] Due to the different amounts of debts that regulators allowed commercial banks and investment banks to assume, a significant discrepancy in debt to equity ratios existed between major commercial banks and major investment banks in September 2008. Commercial banks such as Bank of America, JP Morgan, and Citigroup had debt to equity ratios of 11:1, 13:1, and 15:1 respectively.[54] In contrast, investment banks such as Lehman Brothers, Morgan Stanley, and Goldman Sachs had a debt to equity ratio of 30:1, 30:1, and 22:1 respectively.[55] While markets were booming, a higher debt-to-equity ratio allowed investment banks to have earnings amplified by their leverage ratio, more so than their counterparts at commercial banks.[56] However, investment banks were much less prepared for a downturn due to a much lower buffer of capital reserves to draw upon in bad economic times.[57]

Some believe that the discrepancy between investment banks and commercial banks with regards to their levels of leverage is problematic. Senator Charles Schumer, senior Senator from New York, stated, "Commercial banks continue to be supervised closely and are subject to a host of rules meant to limit systemic risk. But many other financial institutions, including investment banks and hedge funds, are regulated lightly, if at all, even though they act in many ways like banks."[58] Barney Frank and other senior Democrats argue that investment banks compete with commercial banks and

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[52] Andrews, *supra* note 35.
[53] Bajaj, *supra* note 1.
[54] *Id.*
[55] *Id.*
[56] *Id.*
[57] *Id.*
[58] Andrews, *supra* note 36.

should be subjected to similar regulation.[59] This would include examiners inspecting their financial records and regulators demanding changes in operations deemed too risky.[60] In the absence of this, investment banks may operate in too risky a fashion and fail, and the situation might create incentives for commercial banks to shirk existing rules and standards.[61] Less stringent capital standards allow for much more aggressive investing through debt, and it can lead to the kinds of problems that the investment banking world has experienced recently.[62]

Still others, including SEC Chairman Cox disagree. Cox, in his testimony before Congress, stated, "Regulatory reform should recognize the fundamental difference between investment banks and commercial banks."[63] Cox also stated that it would be a mistake to extend commercial banking regulations to investment banks.[64] Chairman Cox mentioned this, however, while noting that the Gramm-Leach-Bliley Act blurred many of the distinctions between commercial and investment banks.[65]

F. Conclusion

Almost everyone agrees that the current system of financial regulation in the United States is out of date and in need of serious reform. The structure and form that these revisions take is a matter than the next Congress and President will shape. Whatever form the new regulations take, it is highly unlikely that the kinds of gaps in investment bank regulation that have existed in the past will continue.

Michael Sloan[66]

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[59] *Id.*
[60] *Id.*
[61] *Id.* (relating a story wherein Congressman Barney Frank once asked the chairman of Citigroup why they had kept certain types of investment off of their balance sheets, to which the chairman replied that if the firm had kept them on the books, they would have been at a disadvantage relative to investment banks who are subjected to much less stringent capital standards).
[62] *Id.*
[63] Zumbrun, *supra* note 21.
[64] *Id.*
[65] *Id.*
[66] Student, Boston University School of Law (J.D. 2010).

VII. Hedge Funds and the Credit Crisis

A. Introduction

By taking advantage of regulatory exemptions and employing sophisticated investment strategies, hedge funds have traditionally offered high-risk, high-return investments to wealthy investors.[1] However, hedge funds have fared poorly in the current credit crisis. Damaged by the failures of major financial institutions and hindered by government action, hedge funds recently experienced their worst month in ten years in terms of overall performance, and currently face an uncertain future.[2] This article will begin by reviewing the traditional role of hedge funds in terms of their operation and regulation. It will then examine the impact of the current credit crisis on hedge funds, and conclude by considering the possible future of hedge funds in the aftermath of the crisis. Preliminarily, if hedge funds are subject to more regulation, they may enjoy more protection from government actions that proved damaging during the fall of 2008, such as the Securities and Exchange Commission's ("SEC's") ban on short-selling, but will likely decline in profitability; if hedge funds remain largely unregulated, they will likely remain highly profitable, but will also remain vulnerable to government actions.

B. The Structure and Operations of Hedge Funds

Hedge funds are largely unregulated investment vehicles that allow managers to generate enormous returns by employing complex investment strategies.[3] While hedge funds have proven their utility by generating returns substantially greater than those of mutual funds, they have also come under increased public scrutiny over the past decade.[4] High-profile failures and instances of illegal conduct by

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[1] Ian D. Prior, *An Opportunity Lost*: *The U.S. Securities and Exchange Commission's New Rule Requiring Registration of Hedge Fund Advisers Has an Achilles Heel—And Hedge Funds Will Take Advantage*, 25 ANN. REV. BANKING L. 471, 472 (2006).
[2] Donna Kardos, *Brutal September for Hedge Funds*, WALL ST. J., Oct. 8, 2008, http://online.wsj.com/article/SB122347650717115365.html.
[3] Prior, *supra* note 1, at 472.
[4] *Id.* at 479.

fund managers have prompted calls for increased regulation.[5] In 2004, the SEC issued a rule requiring all hedge fund advisers to register under the Investment Advisers Act; however, in 2006 a federal court struck down the rule, sending it back to the SEC for review.[6] Currently, the SEC's ability to monitor hedge funds remains questionable from both a legal and a practical standpoint.

A brief summary of current securities regulation is essential to a proper understanding of the hedge fund industry. Four major federal laws regulate the securities industry: the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, and the Investment Advisers Act of 1940. Collectively, these acts provide a regulatory framework requiring investment advisers to register with the SEC and submit to a certain degree of transparency regarding their business practices.[7]

Traditionally, hedge funds have relied upon exemptions within the various regulatory acts to escape registration and government oversight.[8] The Investment Company Act of 1940 contains two exemption provisions that hedge funds routinely use to qualify for an exemption from the registration requirement. Section 3(c)(1) exempts from registration companies with 100 or fewer investors.[9] Section 3(c)(7) classifies institutional and individual investors with a net worth greater than $5 million as qualified purchasers and exempts from registration investment companies whose investors are all qualified purchasers.[10]

Hedge funds also enjoy exemption from the Securities Act of 1933. Pursuant to Rule 506 of Regulation D, securities may be exempt from registration if offered for sale via private offering, rather than public advertisement or solicitation, to "accredited investors," i.e. individuals with at least $200,000 in annual income, $300,000 of combined income, or net worth of $1 million.[11] This allows fund units or shares to be placed with investor with a minimum of SEC involvement or oversight.

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[5] *Id.* at 480.
[6] 17 C.F.R. §§ 275, 279 (2008); *Goldstein v. SEC*, 451 F.3d 873, 883 (C.A.D.C. 2006).
[7] Prior, *supra* note 1, at 473.
[8] *Id.* at 475.
[9] Investment Company Act of 1940, 15 U.S.C. §80a-3(c)(1) (2000).
[10] *Id.* at §80a-3(c)(7) (2000).
[11] 17 C.F.R. § 230.502(c) (2005).

The Investment Advisers Act of 1940 ("IAA") mandates registration for anyone who "engages in the business of advising others . . . as to the advisability of investing in, purchasing or selling securities."[12] However, the IAA allows an exemption from the registration requirement for any adviser who has fewer than fifteen clients, does not hold him or herself out to the public as an adviser, and does not advise a registered investment company.[13]

The Securities Exchange Act of 1934 requires registration of all securities brokers and dealers and all issuers who have more than 500 holders of a class of equity securities in addition to more than $10 million in assets.[14] Conversely, registration is not required for non-brokers, non-dealers, or issuers with fewer than 500 holders of equity securities and less than $10 million in assets.

Collectively, these exemptions create the niche within which hedge funds operate and largely define their structures. Hedge funds do not solicit investment from the public but instead attract investment through private offerings to wealthy individual or institutional investors.[15] Corporations, limited liability companies, pension funds, trusts, university endowments, and other large entities may still count as one investor for exemption purposes.[16] Hedge fund managers classify themselves as traders, rather than brokers or dealers, and limit the number of participating equity holders.[17]

By employing complex investment strategies not available to traditional mutual funds, hedge funds have traditionally offered investors higher rates of return.[18] One important example is short selling: an investor borrows a stock he expects to decline in value, sells it while the price remains high, repurchases after the value has dropped, pockets the difference, and returns the shares to the lender.[19] Short selling, then, is a tool that enables hedge funds to remain profitable even in a bear market. As such, it allows fund managers to "hedge" their bets by taking short positions on certain

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[12] Investment Advisers Act of 1940, 15 U.S.C. § 80b-2(a)(11) (2000).
[13] *Id.* at § 80b-3(b)(3).
[14] Securities Exchange Act of 1934, 15 U.S.C. § 78*l*(g)(1)(B); 17 C.F.R. § 240.12g-1 (2005).
[15] Prior, *supra* note 1, at 477.
[16] *Id.* at 477, 481.
[17] *Id.*
[18] *Id.* at 478.
[19] *Id.* at 474.

stocks while simultaneously purchasing other stocks with the expectation that prices will go up.[20]

Thus, by utilizing short-selling and other complex investment strategies, hedge funds are able to generate substantial profits even in a down market. For example, in September 2008, even as the credit crisis roiled the markets, one manager's funds still averaged a nineteen percent return, with the strongest performer posting a gain of nearly 590 percent.[21] Like mutual fund managers, hedge fund managers charge a fee equivalent to 1 percent of all funds under management. [22] However, unlike mutual fund managers, hedge fund managers also charge a fee of twenty percent of the fund's total profits.[23]

Despite this record of strong performance, hedge funds have attracted a good deal of negative publicity. In the late 1990s and early 2000s, a number of hedge funds made national headlines, illustrating the risks inherent in the hedge fund industry and provoking calls for greater government oversight.[24] In some instances, the problem was managerial dishonesty. In one highly publicized case, a federal judge sentenced Samuel Israel III, founder of Bayou Management, LLC, to twenty years in prison and ordered him to forfeit $300 million after defrauding investors.[25] Sometimes, however, even honestly managed funds simply failed. In 1999, Long-Term Capital Management suffered losses of 90 percent when the Russian government defaulted on its debt payments, prompting a hastily organized rescue by outside investors and drawing attention to the risky strategies that the fund had utilized.[26] To the public, hedge funds—unregulated by the SEC, undefined by statute, and with managers using largely undisclosed, esoteric strategies to make billions of dollars—appeared to be a form of high-stakes gambling for the ultra-wealthy, and inspired a certain amount of unease.

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[20] *Id.*
[21] William Hutchings, *Paulson Breaks Record as Returns Defy Downturn*, FIN. NEWS ONLINE, Oct. 1, 2008, http://www.efinancialnews.com/homepage/content/2452026834.
[22] Prior, *supra* note 1, at 478.
[23] *Id.*
[24] *Id.* at 479-80.
[25] Reuters, *Hedge Fund Founder Given 20 Years for Investor Fraud*, N.Y. TIMES, Apr. 15, 2008, at C3.
[26] Gretchen Morgenson, *Hedge Fund Reimburses $1.3 Billion to Investors*, N.Y. TIMES, July 7, 1999, at C1.

Nonetheless, hedge funds play an important role in the financial markets. As noted, hedge funds have a demonstrated capacity to generate profits even in the midst of a market downturn, thus providing valuable sources of capital. Furthermore, hedge funds offer high-yield investment opportunities for investors who are sufficiently capitalized to absorb significant losses.[27] Despite the negative publicity that the hedge fund industry has attracted in recent years, there is thus a strong argument that hedge funds should continue to operate largely as they have traditionally operated, free from undue government oversight.

C. Hedge Funds and the Credit Crisis

While the high-profile failures or acquisitions of such Wall Street mainstays as AIG, Bear Stearns, and Lehman Brothers have been at the epicenter of the current financial crisis, hedge funds have also fared poorly. September 2008 was the worst month for hedge fund performance in a decade, with funds falling an estimated average of 5 to 9 percent in value.[28] A number of related factors account for the poor performance. First, the successive failures of investment banks caused massive losses to hedge funds for a variety of reasons—some industry-wide, but others specific to the banks role as prime brokers to hedge funds.[29] Second, an SEC ban on short-selling deprived hedge fund managers of a tool crucial to the creative investment strategies they are accustomed to employing to manage risk.[30] Finally, the overall volatility of the markets was especially damaging to funds already constrained by the collapse of the investment banks and the SEC's prohibition on short-selling.[31]

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[27] Prior, *supra* note 1, at 476.
[28] Kardos, *supra* note 2.
[29] Tom Cahill, *Lehman Hedge-Fund Clients Left Cold as Assets Frozen*, BLOOMBERG.COM, Oct. 1, 2008, http://www.bloomberg.com/apps/news?pid=20601109&sid=adjHB.7sfLDA&refer=home.
[30] Tom Lauricella, *Short-sale Ban Wallops Convertible Bond Market*, WALL ST. J., Sept. 26, 2008, at C2.
[31] Jenny Strasburg, *Dow Falls 777.68 Points on Bailout's Delay: A Worry for the Market*, WALL ST. J., Sept. 30, 2008, at C1.

1. The Lehman Brothers Bankruptcy

On September 15, Lehman Brothers announced its intention to file for bankruptcy.[32] Despite its efforts, the investment bank was out of options: the federal government was reluctant to rescue another failed financial institution after brokering the controversial sale of Bear Stearns to JP Morgan Chase and taking over Fannie Mae and Freddie Mac, and eleventh-hour negotiations with Barclay's and Bank of America came to nothing.[33] Lehman's bankruptcy marked the collapse of a Wall Street powerhouse.[34] With the contemporaneous sale of Merrill Lynch to Bank of America, only two major investment banks remained standing.[35]

Lehman's Chapter 11 filing was a disaster for the hedge fund industry. As a prime broker, Lehman had provided loans and trading services to numerous hedge funds. While clients pulled roughly 50 percent of Lehman's prime broker assets out of the troubled firm in the week preceding its Chapter 11 filing, a number of funds did not do so in time.[36] After Lehman declared bankruptcy, those funds found substantial portions of their assets effectively frozen. One firm, Diamondback Capital, saw 14.9 percent of its assets frozen because of Lehman's bankruptcy.[37] Thus, managers were unable to unwind losing positions and could only watch as plunging stock prices wiped out sizable investments.[38] Fund managers fielded anxious phone calls from investors concerned that they might see their own assets frozen if Morgan Stanley and Goldman Sachs, also prime brokers, followed Lehman into bankruptcy.[39]

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[32] Press Release, Lehman Brothers Holdings Inc., Lehman Brothers Holdings Inc. Announces It Intends to File Chapter 11 Bankruptcy Petition (Sept. 15, 2008), http://www.lehman.com/press/pdf_2008/091508_lbhi_chapter11_announce.pdf.

[33] Andrew Ross Sorkin, *Bids to Halt Financial Crisis Reshape Landscape of Wall Street*, N.Y. TIMES, Sept. 15, 2008, at A1.

[34] Ben White & Louise Story, *Titans, After the Fall*, N.Y. TIMES, Sept. 23, 2008, at C1.

[35] *Id.*

[36] Cahill, *supra* note 29.

[37] Joe Nocera, *36 Hours of Alarm and Action as Crisis Spiraled*, N.Y. TIMES, Oct. 2, 2008, at A1.

[38] Cassell Bryan-Low, *Hedge Funds Left in Bind by Collapse of Lehman*, WALL ST. J., Sept. 17, 2008, at C3.

[39] Nocera, *supra* note 37.

2. The Short-Selling Ban

Another blow to the hedge fund industry came a few days later. On September 19, in an effort to shore up a plunging stock market, the SEC announced a prohibition on short sales of the stock of 799 financial companies. [40] The prohibition was to last ten days, but could be extended at the SEC's discretion.[41] Companies could apply to the SEC for inclusion on the list; roughly 200 did so within days of the announcement.[42] Four days later, the SEC revised its rule so that short sales would have to be disclosed to the SEC, but the information would not be published until two weeks later.[43]

The ban on short-selling was a devastating blow to hedge funds. It deprived fund managers of an important means of generating returns in a slumping market.[44] Handcuffed by the SEC, fund managers were unable to take significant steps to minimize loss. The ban effectively shut down the market for convertible bonds, in which investors typically hedge every trade by taking short positions.[45] Prevented from short-selling, investors were unable to hedge and thus unwilling to trade.[46] Managers saw substantial losses: Philip Falcone, a fund manager overseeing some $21 billion at Harbinger Capital Partners, had gone into August with an overall gain of forty-three percent in his biggest fund. A few days after the shorting ban, that gain had shrunk to a mere four percent.[47]

Many hedge funds were in an undesirable position. As discussed, fund managers typically employ complex, high-return investment strategies that allow them to make money even in a down market. However, with assets at Lehman frozen by the investment bank's bankruptcy and the SEC's prohibition leaving managers unable to sell short roughly 1,000 financial stocks, the means to

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[40] Press Release, U.S. Sec. and Exch. Comm'n, SEC Halts Short Selling of Financial Stocks to Protect Investors and Markets (Sept. 19, 2008), http://www.sec.gov/news/press/2008/2008-211.htm.
[41] *Id.*
[42] Kara Scannell & Serena Ng, *SEC's Ban on Short Selling is Casting a Very Wide Net*, WALL ST. J., Sept. 26, 2008, at C1.
[43] Kara Scannell, *SEC Quickly Revises Short-selling Rules*, WALL ST. J., Sept. 23, 2008, at A9.
[44] Scannell & Ng, *supra* note 42.
[45] Lauricella, *supra* note 30.
[46] *Id*.
[47] Jenny Strasburg & Gregory Zuckerman, *More Pain, Less Gain for Big Hedge Funds*, WALL ST. J., Sept. 26, 2008, at C3.

implement those complex strategies were increasingly unavailable to many hedge fund managers.[48] It was apparent that the markets would only grow more volatile before the end of the month, and that fund managers would be restricted in their ability to weather the storm.

3. The Congressional Bailout Plan

By late September, Congress was negotiating a bailout plan, and the markets were fluctuating with the bill's likelihood of passage.[49] When the House of Representatives voted down the $700 billion bailout plan, the market plunged. U.S. stocks lost a cumulative $1.3 trillion in value, and the hedge fund industry continued to suffer.[50] In one dramatic example, as Congress continued to work towards a bailout plan, Washington Mutual went into receivership, costing Texas Pacific Group the entirety of its $1.35 billion investment in the bank.[51]

Investors were understandably panicking. With the September 30 deadline for redemption requests looming for many funds, some hedge funds were seeing withdrawal requests for up to twenty-seven percent of their net asset value.[52] Managers took steps to keep clients from pulling their money. Some resorted to cutting their fees by as much as half.[53] Others limited withdrawals from funds, preventing skittish investors from taking their money out.[54] Despite these efforts, hedge funds were not faring well. In late September, industry experts were estimating that up to one-fifth of all hedge funds would go out of business and hedge fund assets

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[48] Scannell, *supra* note 43.

[49] David M. Herszenhorn, et al., *Day of Chaos Grips Washington*, N.Y. TIMES, Sept. 26, 2008, at A1.

[50] Frederic Tomesco & Sree Vidya Bhaktavatsalam, *Fund Managers Rattled by Rescue Plan's Rejection*, BLOOMBERG.COM, Sept. 30, 2008, http://www.bloomberg.com/apps/news?pid=20601082&refer=Canada&sid=acpVGEFPzQmc.

[51] Peter Lattman, *WaMu Fall Crushes TPG*, WALL ST. J., Sept. 27, 2008, at B1.

[52] Katherine Burton & Tom Cahill, *Ainslie, Einhorn, Stock Hedge Funds Post Record Drops*, BLOOMBERG.COM, Oct. 3, 2008, http://www.bloomberg.com/apps/news?pid=20601087&refer=home&sid=anpijpx6lpec.

[53] Cassell Bryan-Low, *Hedge-Fund Managers Doing Deals to Keep Investors*, WALL ST. J., Oct. 1, 2008, at C2.

[54] *Id.*

would decline by ten percent to twenty percent as investors pulled out.[55]

D. Conclusion

It may be too soon to tell whether the SEC's mid-September ban on short-selling was a prudent measure. However, it is indisputable that the ban deprived managers of an important means of mitigating loss. The companies on the no-short list quickly grew past 1,000, equivalent to one-seventh of all stocks traded on U.S. exchanges.[56] As these securities accounted for roughly 20 percent of the securities that fund managers routinely cycle through their portfolios, fund managers were unable to take steps to minimize losses.[57]

Fund managers found themselves facing steep losses despite taking protective measures earlier in the year. The first half of 2008 saw a growth rate of only 4.3 percent among hedge funds, a six-year low.[58] Anticipating further setbacks, investors and managers took steps to insulate themselves against further loss. By midsummer, cash balances rose to a record $155 billion as managers reduced their investments in anticipation of further market turmoil.[59] Thus, the credit crisis has demonstrated the particular vulnerability of even prudently managed hedge funds to government action and collateral damage from the failures of larger financial institutions.

The credit crisis has provoked widespread calls for increased government oversight of the United States' financial sector.[60] A regulatory scheme in which the federal government takes a larger, or more active, role may emerge. However, while hedge funds have fared poorly over the past year, government and media attention has centered on larger financial institutions such as investment banks and insurance companies. Thus, there is little to indicate that hedge funds

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[55] Strasburg, *supra* note 31.
[56] Scannell & Ng, *supra* note 42.
[57] Jenny Strasburg & Craig Karmin, *Hedge Funds Adjust Their Trading Models*, WALL ST. J., Sept. 20, 2008, at B3.
[58] Donna Kardos, *Survey of Hedge Funds Finds 35% Lost Assets*, WALL ST. J., Sept. 9, 2008, at C4.
[59] David Gaffen, *Market Perplexes Hedge Funds, Too*, WALL ST. J., Sept. 10, 2008, at C6.
[60] Alex Berenson, *How Free Should A Free Market Be?*, N.Y. TIMES, Oct. 4, 2008, at WK1.

will find themselves subject to additional direct government oversight in the aftermath of the financial crisis.

If a new regulatory scheme emerges that does not address the hedge fund industry directly, fund managers may continue to enjoy flexibility and freedom of action. However, such a scheme would also be unlikely to take the interests of hedge funds into account in formulating policy. It would likely leave funds vulnerable to government actions taken with other interests in mind, such as September's ban on short-selling. Conversely, a scheme that does consider hedge funds will likely offer greater protection from such government actions. However, the tradeoff will almost certainly be greater regulation, and thus reduced profitability. The future of the hedge fund industry will therefore depend largely on how the federal government's role in financial markets is redefined in the aftermath of the credit crisis.

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VIII. Impact of Credit Crisis on Private Equity Markets

A. Introduction

U.S. and global financial markets are in a crisis. The situation has been described as the worst since the Great Depression.[1] On November 14, the Dow was down forty percent from the closing high of 14,164.53 on October 9, 2007.[2] "Deflation" is being tossed around in the news.[3] Frozen credit markets, sharp declines in stock prices, financial instability, and a transition in U.S. government power all present serious problems for the private equity industry. But despite the crisis, and to a degree from it, opportunities persist. This article will begin with a brief overview of the traditional private equity business model. Next, the effects of the credit crunch on different segments of the private equity industry are addressed. Thereafter, a discussion will be made regarding emerging industry trends and new opportunities. Finally, challenges to the industry, other than credit, are discussed.

B. The Basic Private Equity Business Model

The business model for a traditional private equity buyout fund is straightforward. When a fund decides to acquire a company, it will use the target company's assets as collateral to borrow most of the money needed for the transaction from banks and reorganize the business for later sale or liquidation.[4] Without credit, the private equity industry is unable to engage in buyout activities.[5]

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[1] James Mawson, *What the Move From Credit Crunch to Super Crisis Will Mean*, http://www.penews.com/archive/keyword/super+crisis/1/content/2451901821 (last visited Oct. 10, 2008).

[2] Joe Bel Bruno and Sara Lepro, *Wall Street Ends Turbulent Week Sharply Lower*, ASSOC. PRESS, Nov. 14, 2008, http://news.yahoo.com/s/ap/20081114/ap_on_bi_st_ma_re/wall_street.

[3] Peter S. Goodman, *Fear of Deflation Lurks as Global Demand Drops*, N.Y. TIMES, Nov. 1, 2008, at A1.

[4] Thomas Heath, *Private Equity's Loss of Leverage*, WASH. POST, Jan. 2, 2008, at D08.

[5] *See generally id.*

C. Decline in Buyout Activity

Private equity buyouts are broadly categorized based on the dollar amount of the buyout. "Large" buyouts are considered those over $1 billion[6], while smaller "middle market" buyouts are those between $500 million and $1 billion.[7] A reduction in the amount of credit available has implications for these primary market segments.

1. Dramatic Slowdown in Large Buyouts

In June 2007, credit froze quite abruptly and large buyout transactions, generally considered as those over $1 billion and funded by a syndicate of banks, came to a halt.[8] This trend has continued throughout 2008. First quarter deals were down 70 percent compared to 2007.[9] Through October 1, deals were down 72 percent to $177 billion.[10] Some analysts do not predict any syndicated deals for the remainder of 2008, and others seem to agree, calling any predictions "utter folly" because of the current instability of the lending industry.[11]

Despite the abrupt halt in large buyout transactions and grim short-term predictions, some optimism remains. At least one analyst believes that private equity should be insulated from the worst effects of the crisis because of its long-term committed capital.[12] Further, "[private equity] portfolio companies can survive if they make it through the next two to three years once the debt amortization and

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[6] PRIVATE EQUITY ANALYST, 2007 REVIEW AND 2008 OUTLOOK 15 (2008), *available at* http://info.dowjones.com/forms/PEAOutlookandReview (fill out the form to be redirected to the .pdf version of the document).

[7] *Forget Those Big Deals (and Headlines): Private Equity Firms Are Shopping the Middle Market*, Mar. 5, 2008, KNOWLEDGE@WHARTON, http://knowledge.wharton.upenn.edu/article.cfm?articleid=1908.

[8] PRIVATE EQUITY ANALYST, *supra* note 6 (depicting graphically a "free fall" in the number of large buyouts in the previous twelve months).

[9] *In Tougher Times, Carlyle Looks Abroad*, N.Y. TIMES, May 2, 2008, http://www.nytimes.com/2008/05/02/business/worldbusiness/02carlyle.htm.

[10] Michael Karnitschnig & Dana Cimilluca, *Quarterly Markets Review: Merger Activity Proves a Bright Spot as Sellers Rush to Survive*, WALL ST. J., Oct. 1, 2008, at C8.

[11] Toby Lewis, *Banking Crisis Places Most Buyouts on Hold Until 2009*, PENEWS.COM, Oct. 9, 2008, http://www.penews.com/today/index/content/2452106904 (last visited Oct. 10, 2008).

[12] Mawson, *supra* note 1.

leveraged refinancing start to hit and the default wave spikes. This should give firms unprecedented buying opportunities. And investors can also buy into this eventual uptick through listed private equity shares and leveraged loans sitting on deep discounts to net asset or par value."[13] In addition, others see opportunities for private equity to engage in new kinds of investments and predict private equity firms will emerge from this financial crisis resembling investment conglomerates Berkshire Hathaway and General Electric.[14]

There is likely something to all these predictions. Markets (and prices) inevitably fluctuate just as businesses inevitably innovate. Any regulatory changes in the financial services industry will certainly play a role in the future look of private equity, but it is uncertain what lies beyond any temporary regulatory changes at this point. In particular, the exact policies the Obama administration will implement are still unknown. Until the new administration implements its policies of at least the next four years, there is little reason to suspect lenders will be willing to commit billions of dollars in long-term financing in the immediate future. The news in the next six months will likely be silent on news of large buyouts, with the possible exception of distressed asset deals, which may exceed $1 billion.

2. Slowdown in the Middle Market

So far, the impact of the credit crunch appears to be less substantial on the middle market, where deals range from $500 million to $1 billion.[15] Deals at this level "are often financed by regional and community banks, which so far haven't been sapped by sub-prime losses. Many of these banks are still willing to lend, though they have become more cautious."[16] The segment is not immune from the credit crunch, however, and transaction activity is showing some signs of slowing.[17] Moreover, these buyouts may suffer due to the sale of Wachovia Bank, a major player in the middle

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[13] Mawson, *supra* note 1.
[14] Heath, *supra* note 4.
[15] *Forget Those Big Deals (and Headlines)*, *supra* note 7.
[16] *Id.*
[17] *See generally* Andy Peters, *K&S Partner: Private Equity Deals Have Ceased Across the Board*, DAILY REP. ONLINE, Oct. 24, 2008, http://www.dailyreportonline.com/Editorial/News/singleEdit.asp?individual_SQL=10%2F24%2F2008%4027062 (last visited Oct. 24, 2008).

market lending space.[18] The sale is predicted to shrink the amount of debt available for these transactions.[19] Whatever the driving force behind the stalling middle market—available credit, valuation problems, recession fears—it is now clear that the entire private equity industry is experiencing a slowdown.

D. Industry Trends

Like any industry facing a slump in the global economy, the private equity industry is experimenting with new strategies. Because of private equity's reliance on the now-frozen credit markets, the industry has been "boosting investment in emerging markets, taking minority stakes in companies and buying distressed assets, a lot of which do not require as much of the cheap bank debt that fueled the recently stalled buyout boom."[20] Not all of these strategies are universally regarded as sound, however, particularly investments in overseas markets where corporate law is less developed.[21]

Notwithstanding the legal uncertainty, international diversification seems to be the predominant strategy on coping with a stagnant U.S. economy. Interest in international buyouts was growing before the financial markets froze, and today the belief remains that "[b]ig [U.S.] private-equity firms will continue to expand their buyout presence in such places as China, India, Brazil, the Middle East and South Africa, where some economies are growing faster than [in the U.S.]"[22] For example, Carlyle Group, one of the largest private equity firms, currently holds 64 percent of its investments in North America but anticipates "that within five years, about two-thirds of the [its] investments will be in non-U.S. companies."[23] Among European countries, "Poland and Romania will attract the most attention, with consumer, industrials, [the

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[18] Shasha Dai, *Wachovia's Sale to Tighten Mid-Market Lending*, PENEWS.COM, Sept. 30, 2008, http://www.penews.com/archive/keyword/wachovia/1/content/2452015440 (last visited Oct. 10, 2008).
[19] *Id.*
[20] *Funds Find New Options in Slow LBO Market*, PRIVATE EQUITY WK., June 9, 2008, at 8.
[21] *Id.*
[22] Heath, *supra* note 4.
[23] *In Tougher Times, Carlyle Looks Abroad, supra* note 9.

technology, media, and telecommunications sector,] and business services as the most alluring sectors for buyout activity."[24]

The trend toward international private equity trends mirrors the much broader trend of increased international commerce. The global environment, while it does provide new opportunities, also presents new legal and cultural challenges. As previously mentioned, differences in corporate law raise potential difficulties. There are also labor, environmental, language, political, cultural and expertise problems that can arise when a company purchases and operates foreign businesses. But with credit frozen and a stagnant or recessionary domestic economy, international investment seems to be an attractive strategy. As best practices are developed, the challenges and increased costs of international investment can be mitigated.

E. New Opportunities from Financial Collapse

1. Distressed Assets

Private equity firms are estimated to have $450 billion in uncommitted capital.[25] This means that if a company is forced to sell otherwise valuable assets to satisfy the demands of its creditors, private equity firms can acquire those assets at relatively cheap prices. Such is the case with American International Group ("AIG"). Forced to sell some of its assets, the liquidation of many AIG assets generated a "feeding frenzy" among several private equity firms.[26]

Although investors in private equity firms are expecting a return on their investment, investors generally have no short-term redemption rights if unsatisfied with their returns.[27] Thus, private equity firms have the luxury of waiting longer than other investment vehicles to use the un-invested capital they manage before investors withdraw their funds. The timeline for future corporate failures and subsequent asset sales is unknown; AIG is probably just the

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[24] Matt Turner, *Firms Eye Emerging Europe*, PENEWS.COM, July 16, 2008, http://www.penews.com/archive/keyword/middle+market/2/content/2451255239 (last visited Oct. 9, 2008).

[25] *Private Equity and Banks: Loan Rangers*, ECONOMIST, Aug. 28, 2008, at 73.

[26] Heidi N. Moore, *AIG Rings Bell: Feeding Frenzy*, WALL ST. J., Oct. 6, 2008, at C5 (listing the potential buyers and potential portions of AIG's operations that may be bought out).

[27] *Id.*

beginning. Other things being equal, though, private equity firms are in a position to adopt a wait-and-see approach and opportunistically acquire distressed assets as they become available.[28]

2. Joint Ventures in the Retail Industry

Because of the economic slowdown, the retail industry may provide an excellent opportunity for private equity. Lack of credit, however, poses substantial problems. The lack of credit available to finance private equity buyouts has "deflat[ed] the stock prices of numerous retailers that were considered ripe for a buyout," including Macy's Inc., J.C. Penney Co., Best Buy Co., Kroger Co. and TJX Cos.[29] The economy, and retail spending, will pick up again in the future. The challenge for private equity is finding a way to finance these buyouts. One potential solution could be through joint ventures between corporations and private equity firms, which could provide a much-needed boost to the mergers-and-acquisitions market, stalled since the credit crunch took hold."[30]

Joint ventures, however, are ripe for conflicts. These particular arrangements are probably only viable when a private equity firm and a corporation can agree to liquidate the jointly acquired company. There would be inevitable differences in strategy and priorities between corporate and private equity co-owners should there be an agreement to jointly manage the firm. But, for example, if Best Buy and Blackstone agree to purchase and liquidate Circuit City (all antitrust issues aside), it may prove to be a win-win for both parties at a time when neither alone could accomplish their individual goals.

F. Sovereign Wealth Funds

Private equity firms are not the only investment vehicles affected by the credit crisis and looking to expand into new areas. Increasingly, competition is coming from abroad and in particular

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[28] Jonathan Henes, *Private Equity Opportunity: Buy The Distressed*, CNBC.COM, Oct. 24, 2008, http://www.cnbc.com/id/27362365 (last visited Oct. 24, 2008).
[29] James Covert, *Retailers Seek Their Own Deals*, WALL ST. J., Sept. 12, 2007.
[30] Dana Cimilluca et al., *Out of Necessity, Old Foes Unite*, WALL ST. J., Aug. 27, 2008, at C2.

from sovereign wealth funds ("SWFs"),[31] which "in early 2008 totaled some $2.5 trillion."[32] In 10 to 15 years, some predict [SWFs] could be worth $15 to $20 trillion.[33] Morgan Stanley even went so far as to estimate that [SWFs] could soon bypass the forex reserves of some central banks.[34]

With all this capital, SWFs clearly present a threat to private equity.[35] If SWFs and private equity firms compete for acquisition targets, prices will rise, and this will have a bigger impact on the private equity firm rather than a SWF, which, due to size, can rely less on credit to finance transactions. By investing directly into companies, SWFs may also prevent an opportunity from ever presenting itself in the first place. For example, the SWF of Abu Dhabi invested $7.5 billion into Citibank in 2007[36] and recently invested $8.4 billion into chipmaker AMD.[37] Although these were non-controlling investments,[38] such investments may prevent a struggling company from spinning off a segment of its business that private equity may wish to acquire.

On the other hand, if a SWF invests directly into a private equity fund, it would provide additional capital and enable larger transactions in the future. SWFs could also act as a buyer for companies and assets held by a private equity firm. In this role a SWF might purchase a company owned by a private equity firm outright, keeping it private, or purchase shares in an IPO. Either way, growing SWFs help ensure a robust market for the sale a private equity fund's portfolio companies.

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[31] *Huge Reserves, Emerging Market 'Challengers' and Other Forces Are Changing Global Finance* (2008), KNOWLEDGE@WHARTON, http://knowledge.wharton.upenn.edu/article.cfm?articleid=2055.
[32] *Id.* (comparing SWF estimates to "some estimates for private equity firm investment pools of $1 trillion, hedge funds of about $5 trillion, U.S. mutual funds of $10 trillion and pension funds of $60 trillion.").
[33] *Id.*
[34] *Id.*
[35] *Id.*
[36] Zachary Karabell, *Saviors of the Citi*, WALL ST. J., Nov. 30, 2007, at A17.
[37] Don Clark, *Abu Dhabi Doubles Down on AMD Investment*, WALL ST. J., Oct. 8, 2008, at B3.
[38] *Id.*

G. Banks and Bank-Holding Companies

In response to the financial crisis, the Federal Reserve ("Fed") recently eased its definition of what amounts to "control" of a banking institution, stating, "An investor can take as much as 33% equity interest, of which 15% can be voting common stock, without being deemed a controlling investor."[39] With these eased restrictions, private equity may be more willing to invest capital into banking institutions. Banks are in desperate need of fresh capital, which is an issue when debt is expensive and equity values are low. In numerical terms, "[b]ank write-downs have reached a total of $500 billion . . . but big lenders have raised only about $200 billion of tier-one capital."[40] With $450 billion in uncommitted capital,[41] private equity firms are in a position to negotiate favorable terms with banks.

Some private equity firms have already invested into banks, but not without a degree of investor backlash:[42]

> Texas Pacific Group's (TPG) recent investment in Washington Mutual (WaMu) massively diluted shareholder stakes by handing 50.2% of the company to TPG and its partners. While the deal -- crafted in secret without shareholder input or approval -- has already put $50 million in transaction fees in the pocket of TPG, WaMu shareholders have seen their stock value fall to $5.38 a share, the lowest level in 16 years (a nearly 90% drop in the last year alone).[43]

Of course, what Washington Mutual shares might be worth in the absence of a private-equity capital injection is mere speculation, but in all probability, the bank was probably prudent to engage in an equity transaction with TPG. If the credit markets are indeed frozen and shares were already trading low and at highly volatile levels, relatively easy capital from private equity seems to be

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[39] Peter Lattman & Damian Paletta, *Funds Get Freer Hand In Buying Bank Stakes*, WALL ST. J., Sept. 23, 2008, at A1

[40] *Private Equity and Banks: Loan Rangers*, *supra* note 25.

[41] *Id.*

[42] Andy Stern, *Keep Private Equity Away From Our Banks*, WALL ST. J., July 7, 2008, at A13.

[43] *Id.*

a good business decision, considering the rather short list of alternatives.

H. Conclusion

Because of recent financial instability and frozen credit markets, traditional private equity buyout activity has essentially stopped. A few trends, however, are emerging. The private equity boom of the past few years has left the industry sitting on roughly $450 billion of uncommitted capital. The industry is expected to put this capital to use in new ways and in new industries, particularly in distressed assets and emerging markets where debt is not as critical. Financial institutions are in desperate need of capital. The Federal Reserve's recent relaxation of what constitutes "control" of a bank ought to attract private equity investment to banks, even if it means departing from traditional practices and making non-controlling investments.

Entirely new investment strategies always carry additional risk above what is already expected. This is true particularly in the international context, where strict or unfamiliar corporate laws and regulations can impede managerial discretion. For an industry primarily engaged in corporate reorganizations and liquidations, foreign laws can present a real problem for the traditional private equity buyout model. However the private equity industry emerges from the current economic crisis, the financial landscape will be different. The traditional private equity buyout model will need to be modified, one way or another, to address these inevitable challenges and maintain profitability in an increasingly risky environment.

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IX. Auction-Rate Securities: Freezing Investor's Cash

A. Introduction

In February 2008, the market for auction-rate securities, a segment of the debt market, collapsed. The financial turmoil that began in 2007 took a severe toll on what had previously been considered, for liquidity reasons, a "cash-equivalent" market.[1] Because of the subprime mortgage crisis and the following credit crunch, interested buyers stopped showing up at the purchasing auctions for auction-rate securities.[2] Without a sufficient number of buyers, the auctions became susceptible to failure as their success depended solely on market demand.[3] When investment banks and broker-dealers could no longer step in as bidders of last resort, thousands of auctions failed leaving investors with their cash frozen in illiquid securities in an illiquid market.[4]

This article will begin by providing background information on the auction-rate securities market and explain the auction process whereby such instruments are offered to investors. The focus will be on securities issued by municipal and tax-exempt entities and the impact of the auction failures both on these entities and on the purchasers of the instruments. Thereafter, it will discuss the inherent risks of auction-rate securities and the amplification of such risks due to the housing bubble and credit crunch. Lastly, it will address recourse options available to investors and attempt to delineate the lessons learned from the auction-rate securities debacle.

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[1] Megan Johnston, *Auction-Rate Securities Suffer Total Insecurity*, FINANCIALWEEK.COM, Feb. 18, 2007, http://www.financialweek.com/apps/pbcs.dll/article?AID=/20080218/REG/698824530.

[2] Aaron Pressman, *Auction-Rate Securities: Out of Luck*, BUSINESSWEEK.COM, May 27, 2008, http://www.businessweek.com/investor/content/may2008/pi20080527_737272.htm.

[3] *Id.*

[4] Aaron Pressman, *UBS: Auction-Rate Securities Collapse*, BUSINESSWEEK.COM, July 20, 2008, http://www.businessweek.com/magazine/content/08_32/b4095000912782.htm?chan=investing+index+page_stocks+%2Bamp%3B+markets.

B. Background of Auction-Rate Securities Market

Since first issued in 1984,[5] the auction-rate securities market ballooned to nearly $330 billion by early 2008.[6] It became increasingly popular, especially within the last decade, as institutions experimented with unconventional financial instruments in an effort to lower the costs of borrowing.[7] In addition, the securities found especial favor among public and non-profit issuers, who became the fastest-growing participants in the auction-rate securities market.[8]

Auction-rate securities are essentially long-term debt instruments that behave like short-term investments.[9] They have long maturities, ranging between twenty to thirty years, yet the interest rates are reset regularly through a formalized bidding process known as a "Dutch" auction,[10] which takes place every seven, fourteen, twenty-eight or thirty-five days.[11] This frequency gives the securities a risk-profile similar to short-term investments and makes the instruments highly liquid.[12] Indeed, each auction provides investors an opportunity to cash out their investments.

At the auction, potential buyers specify to a broker-dealer the number of shares they wish to purchase and the lowest interest rate

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[5] Stephanie Lee, NERA Econ. Consulting, *Auction-Rate Securities: Bidder's Remorse*, May 6, 2008, http://www.mmc.com/knowledge center/NERA_PUB_Auction_Rate_Securities.pdf.

[6] Adrian D'Silva et al., *Explaining the Decline in the Auction-Rate Securities Market*, The Federal Reserve Bank of Chicago No. 256, (Nov. 2008), http://www.chicagofed.org/publicaations/fedletter/cflnovember2008 256. pdf.

[7] David Cho & Tomoeh Murakami Tse, *Credit Crisis Adds Millions to D.C.'s Interest Payments*, WASH. POST, April 7, 2008, at A01.

[8] Douglas Skarr, Issue Brief, California Debt and Investment Advisory Commission, Auction-Rate Securities, (August 2004), http://www.treasurer. ca.gov?Cdiac/issuebriefs/aug04.pdf.

[9] *Id.*

[10] *Id.* In a Dutch auction, an agent accepted bids at successively higher rates until it was possible to sell all the securities available for sale. *Practices and Procedures of Citigroup Global Markets, Inc.*: *Auction Rate Securities*, CitiSmithBarney, https://www.smithbarney.com/products_services/fixed_ income/auction_rate_securities/.

[11] Skarr, *supra* note 8.

[12] Karl D'Cunha, *The Untold Story of the Auction-Rate Securities*, SEEKINGALPHA.COM, Aug. 14, 2008, http://seekingalpha.com/article/90869-the-untol-story-of-the-auction-rate-securities.

they would accept.[13] An auction agent then receives the bids from the broker-dealers, ranks the interest rate bids and order sizes in ascending fashion, and determines the lowest rate at which all the shares could be sold (the "clearing rate").[14] Investors bidding at or below the clearing rate receive the securities.[15] When this process ran smoothly auction-rate securities had such a high degree of liquidity that many investors considered them—as investment banks marketed them—to be cash-equivalents.

For the issuers of the securities, the auction process provides a cheaper way to finance long-term debt than traditional variable-rate instruments.[16] Auction-rate securities have no letter-of-credit requirement and no need for an annual bond rating as often required for more traditional variable-rate financing.[17] For this reason, the securities became especially attractive to public sector issuers such as municipalities, non-profits, hospitals, housing agencies, student loan authorities and universities.[18] Such issuers made up 75 percent of the auction-rate securities market before its demise.[19]

Goldman, Sachs & Company first made auction-rate securities available to the tax-exempt sector in 1988, touting it as an opportunity for municipal issuers to pay short-term interest rates on long-term debt issues.[20] The prospect found favor within the tax-exempt community.[21] Within the last five years participation in the auction-rate market skyrocketed in the public sector,[22] from a $100

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[13] D'Silva et al., *supra* note 6.
[14] Skarr, *supra* note 8.
[15] D'Silva et al., *supra* note 6.
[16] Skarr, *supra* note 8.
[17] *Id.*
[18] Lee, *supra* note 5.
[19] Lee, *supra* note 5.
[20] *A Dutch Auction Security Debut*, N.Y. TIMES, Mar. 17, 1988 at D6.
[21] For example, in July 2007, the Port Authority of New York and New Jersey issued its first series of auction-rate securities, stating that the issuance would "enable the Port Authority to diversify its debt portfolio, reduce interest costs and increase overall rate exposure." Press Release, The Port Authority of NY & NJ, Port Authority Announces Sale of $350 Million in Versatile Structure Obligations (July 18, 2007), http://www.panynj.gov/abouttheportauthority/presscenter/pressreleases/PressRelease/index.php?id=966.
[22] Issuers used these debt instruments to fund long-term projects such as roads, bridges, and buildings, as well as to meet general financing needs. Lee, *supra* note 5.

billion market in the first quarter of 2002 to a $200 billion market by the end of 2003.[23] Securities issued by this sector represented a majority of the market;[24] it is on this segment of issuers that the article will mainly focus.

Auction-rate securities typically require a minimum investment of $25,000, effectively precluding small individual investors from the market.[25] Therefore, typical market investors include high net worth individuals and corporate treasuries, both looking for an easily accessible place to park money.[26] By early 2008, an estimated one-third of U.S. corporations held such investments.[27] The popularity of the instruments stemmed from the cash-like comfort provided through the auction process and higher investment yields than Treasury securities, money-market funds and certificates of deposit.[28]

Auction-rate securities issued by municipalities and tax-exempt entities are particularly attractive to investors due to the historically high credit ratings of such issuers, a consequence of bond insurance and high levels of collateralization.[29] High credit ratings enable the securities to be considered very low-risk relative to similar securities.[30] The general nature of auction-rate securities makes them very sensitive to changes in credit ratings because the success of the market depends on the faith investors place in the securities.[31] The liquidity of the market hinges on buyers continuing to participate in the auction process and purchase the investments.

However, despite the importance of high credit ratings to the market, such ratings did provide protection against market failure. The 2008 problems in the auction-rate securities markets had little to do with credit valuation issues and more to do with a fundamental lack of liquidity in the market.[32] Investors flocked to auction-rate securities for their cash-like properties, a function of the frequent

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[23] Skarr, *supra* note 8.
[24] *Id.*
[25] *Id.*
[26] Money market funds are not eligible to hold auction-rate securities due to SEC rules. Skarr, *supra* note 8.
[27] Johnston, *supra* note 1.
[28] Pressman, *supra* note 4.
[29] D'Cunha, *supra* note 12.
[30] Skarr, *supra* note 8.
[31] *Id.*
[32] D'Cunha, *supra* note 12.

auction system. This system depended on investors' continued confidence in the market in order to create liquidity. If buyers failed to show up at the auctions, investors holding securities would be left without a way to get their cash out. Thus, credit ratings aside, a major component of the auction-rate securities market was investor confidence, and investors should have been aware that an auction could easily fail at any time due to lack of demand.[33]

C. Risks of the Auction-Rate Securities Market

The auctions for the securities ran relatively smoothly for years, fueling investor perceptions that the securities represented safe, liquid investments.[34] While the auction-rate securities market did not crash until February 2008, there were signs of trouble as early as 2004.[35] In May 2006, following a two-year investigation, the Securities and Exchange Commission ("SEC") fined fifteen broker-dealers a total of $13 million for "auction practices that were not adequately disclosed to investors" in violation of federal law.[36] The charges included asking customers to make or change orders to prevent failed auctions and providing certain customers with information that gave them an advantage over other customers in determining what rate to bid.[37] The charges seemed to demand more disclosure in the market for unsuspecting investors, yet smaller investors were unlikely to find out about these claims and the increased risk posed to the market.[38] While corporate and large investors have accountants and financial teams, smaller investors are often left to rely only on the voluntary disclosure of investment banks and broker-dealers, and broker-dealers did not provide the needed warnings.

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[33] *Id.*

[34] Aaron Pressman, *Auction-Rate Securities: How to Get Unstuck*, BUS. WK., June 2, 2008, at 76.

[35] Pressman, *supra* note 4.

[36] Stan Provus, Council of Dev. Fin. Agencies, *Auction-Rate Securities*, June 2008, http://www.cdfa.net/cdfa/cdfaweb.nsf/pages/spotlightJune2008.html.

[37] *Id.*

[38] John F. Wasik, *Collapse of Auction-Rate Securities Reminds Buyers to Stay Cautious*, TAMPA BAY ONLINE, Sept. 3, 2008, http://www2.tbo.com/content/2008/sep/03/bzcollapse-of-auction-rate-securities-reminds-buy/news-money/.

Interestingly however, despite the negative publicity surrounding auction-rate securities, the markets, for the most part, continued to function. It appeared that despite the unfavorable news from the SEC, either investors did not lose faith in the market or investment banks were ramping up their participation in the market to prevent failed auctions.

In the event of a failed auction, holders of auction-rate securities would have to hold their positions until the establishment of a clearing rate at the following auction.[39] On the issuers' side, their interest rates would revert to a "penalty" or maximum rate often matching the London Interbank Offered Rate ("LIBOR") plus some percentage, making the cost of borrowing more expensive.[40] Such a situation would leave investors' money stuck and issuers forced to pay a much higher rate[41] as there is rarely a secondary market outside of the periodic auctions.[42] Unsurprisingly, before the collapse of the market, banks took an active role to prevent failed auctions by acting as bidders of last resort.[43] This helped to maintain the liquidity of the auction-rate securities markets, although only as a stopgap measure.

In December 2007, problems in the auction-rate securities markets resurfaced and banks began warning their larger clients about "looming trouble" in the market.[44] Remarkably, even in the face of these warnings, investment banks allegedly continued to sell the securities to smaller and individual investors leading them to believe that the securities still represented safe, cash-like investments.[45] Such sales would exacerbate the future effects of the global credit crisis.

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[39] Skarr, *supra* note 8.
[40] D'Silva et al., *supra* note 6.
[41] *Id.*
[42] Lee, *supra* note 5.
[43] Pressman, *supra* note 4.
[44] Beth Healy, *Bank of America Buying Back Bonds*, BOSTON GLOBE, Aug. 28, 2008, at F1.
[45] Andrew Miga, *Mass. AG Wants Help for Auction-Rate Investors*, BOSTON GLOBE, Sept. 18, 2008, http://www.boston.com/business/articles/2008/09/18/mass_ag_wants_help_for_auction_rate_investors/.

D. The Effect of the Credit Crunch on Auction-Rate Securities

In 2007, the housing bubble burst, precipitating a massive credit crisis into 2008. Callous lending practices and tainted subprime mortgages led to massive chaos in the financial markets and auction-rate securities became one of the worst performing segments.[46] The path to destruction of the auction-rate securities market is a testament to the interconnectedness of the financial system.[47] Problems with the mortgage crisis began to scare investors away from all manner of debt, compounding problems in an already troubled auction-rate securities market.[48] Such fears caused many potential investors, especially large corporate investors, to avoid the auction-rate securities auctions. When investors began losing confidence in the market,[49] fewer buyers showed up to purchase the securities, and auctions began failing in record numbers.[50]

In the past, banks kept the securities auctions afloat by acquiring any excess purchased securities in an auction without sufficient bids.[51] When the credit crunch began and investors failed to show up at auctions, banks began buying more auction-rate securities than they were actually prepared to manage on their books.[52] Within a five-month period in 2007, for example, UBS's inventory of auction-rate securities ballooned from $1 billion to $3 billion.[53]

After companies such as Bristol-Myers Squibb ("BMS"), US Airways and 3M began announcing losses on auction-rate securities in the fall of 2007,[54] auditors began to express concern about the market and corporate clients began to dump their investments.[55] At the same time, the heavy load of auctions-rate securities began to take a toll on the balance sheets of the nation's largest investment

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[46] Pressman, *supra* note 2.
[47] Lee, *supra* note 5.
[48] Pressman, *supra* note 4.
[49] Jenny Anderson & Vikas Bajaj, *New Trouble in Auction-Rate Securities*, N.Y. TIMES, Feb. 15, 2008, at C6.
[50] Lee, *supra* note 5.
[51] Pressman, *supra* note 4.
[52] *Id.*
[53] *Id.*
[54] Johnston, *supra* note 1.
[55] Pressman, *supra* note 4.

banks, which began looking for ways to push out the swelling amount of securities.[56] For instance, in August 2007, the head of UBS's auction group allegedly spearheaded a conference call with more than 850 brokers[57] to encourage them to assist in "moving the [auction-rate securities] through the system."[58] In short, investment banks wanted to get the securities off their books to hedge their own exposure.[59] Many individual investors claim their brokers put them into these securities for the first time during the second half of 2007, raising red flags since the timing corresponds to the massive dumping of the investments by their corporate clients.[60]

The banks' desire to clear their books became paramount when, in the fall of 2007, they began suffering significant credit losses and mortgage write-downs after the housing bubble burst.[61] Exposure to subprime tainted securities greatly diminished cash flow and drastically reduced the ability of banks to step in and purchase auction-rate securities at failing auctions.[62] Furthermore, most banks had already saturated their books with the securities.[63] Bidders continued to lose confidence in the auctions, their fears spiraling into a self-fulfilling prophecy as more purchasers failed to show up at auctions to provide the necessary demand for the market.[64] Banks could no longer provide support by taking on additional securities, and when banks failed to step in, the market virtually ground to a halt.[65]

The auction-rate securities market crashed in February 2008 when bidders failed to show up to purchase securities at thousands of auctions, causing the market to collapse.[66] Three days alone in February saw the failure of more than 1,000 auctions.[67] By contrast,

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[56] Pressman, *supra* note 34.
[57] *Id.*
[58] *Id.*
[59] *Id.*
[60] Gretchen Morgenson, *It's a Long, Cold, Cashless Siege*, N.Y. TIMES, Apr. 13, 2008, at BU1.
[61] D'Silva et al., *supra* note 6.
[62] Johnston, *supra* note 1.
[63] UBS alone held almost $7 billion by January 2008. Pressman, *supra* note 4.
[64] D'Silva et al. *supra* note 6.
[65] Pressman, *supra* note 4.
[66] Pressman, *supra* note 2.
[67] Lee, *supra* note 5.

only 44 auctions failed between 1984 and the end of 2007.[68] UBS, Goldman Sachs, Lehman Brothers, Merrill Lynch and other investment banks had to deliver uncomfortable news to investors: the market for auction-rate securities had frozen, and so had their cash.[69]

E. Getting Help for Investors

In an effort to address the concerns of investors, some state officials have stepped in to protect market participants, especially those led to believe that the securities represented alternatives to other safe, liquid investments.[70] The opinion of Massachusetts Attorney General Martha Coakley exemplifies the position of many states: any solutions should return the original investment amount to all investors.[71]

According to a lawsuit filed by Massachusetts, it had been increasingly necessary for banks to step in to keep the auctions from failing, despite the fact that the banks portrayed the markets as safe and self-sustaining.[72] From January 2006 through February 2008, UBS bought securities in 88 percent of the 30,000 auctions it oversaw for municipalities.[73] In July 2008, New York State Attorney General Andrew Cuomo sued UBS for allegedly encouraging investors to buy already distressed auction-rate securities despite the known market troubles.[74] The suit charged UBS with "falsely marketing and selling auction-rate securities as safe, cash-equivalent investments at a time when the market for these securities was under severe strain."[75] Email correspondence within UBS from late 2007 provides valuable evidence:

> We are selling to this group . . . . We need them to walk out and *believe* that this is strong credit w[ith]

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[68] Cho & Tse, *supra* note 7.
[69] Anderson & Bajaj, *supra* note 49.
[70] Miga, *supra* note 45.
[71] *Id.*
[72] Darrell Preston, *Muni Investors Kept in Dark as Finances Unravel*, BLOOMBERG.COM, Oct. 10, 2008, http://www.bloomberg.com/?=0&Intro=intro3.
[73] Pressman, *supra* note 4.
[74] David Ellis, *UBS Hit with New York Auction-Rate Security Suit*, CNNMONEY.COM, July 24, 2008, http://money.cnn.com/2008/07/24/markets/coumo_securities/index.htm.
[75] *Id.*

> [a] strong UBS commitment to *support[ing]* liquidity.[76]

In February 2008, the time of the auction-rate securities market crash, UBS had more than 50,000 accounts holding auction-rate securities worth nearly $25 billion.[77] Cuomo wants these investors to again have access to their funds, especially those invested after the problems in the market became known.[78] The efforts by the states are essentially aimed at increasing investor confidence in the entire market during the current troubled economic times.[79]

Many banks recognize the gravity of the situation as they start to engineer settlements with state regulators. In August 2008, Coakley structured an agreement with Bank of America to reimburse $43 million tied up in auction-rate securities to the Massachusetts Turnpike Authority and the Massachusetts Housing Authority.[80] Both agencies bought the securities before the failure of the auction-rate markets.[81] By August 2008, state regulators had convinced major investment banks such as Bank of America, Citigroup, JP Morgan Chase, Merrill Lynch, Morgan Stanley, UBS and Wachovia to repurchase illiquid auction-rate securities amounting to more than $50 billion.[82] The majority of these settlements are giving small investors—individuals, charities, non-profits and small businesses—priority for compensation over large corporate treasuries.[83] This is

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[76] Email from Edward Hynes, UBS Bank, to Amy F. Monblatt, Chris Long & Joanna Brody, (Nov. 29, 2007, 06:46 EST), http://s.wsj.net/public/resources/documents/WSJ_UBS_Complaint063008.pdf (emphasis added).
[77] Ellis, *supra* note 74.
[78] Grant McCool & Richard Chang, *Bank of America and RBC Settle Auction-Rate Debt Probe*, REUTERS.COM, Oct. 8, 2008, http://www.reuters.com/article/ousiv/idUSTRE4979GR20081008.
[79] *Id.*
[80] Healy, *supra* note 44.
[81] *Id.*
[82] Donna Mitchell, *Auction-Rate Securities Dust Settles, But What About Small Brokerages?*, ONWALLSTREET.COM, Oct. 1, 2008, http:/www.onwallstreet.com/asset/article/707221/auction-rate-securities-dust-settles-but-small.html.
[83] *Id.*

consistent with the SEC's object of getting the small retail investor redeemed early and first.[84]

At the same time, state and federal investigators are also looking into claims of incentivized sales for auction-rate securities. Despite evidence to the contrary, UBS has rejected "any claim that the firm engaged in a widespread campaign to move . . . inventory from the firm's own books and into private accounts."[85] Such denials suggest that banks want investors to believe that the markets functioned for years without problems and then imploded without warning.[86]

Attorneys are now beginning to recognize the potential for lawsuits against investment banks. Many feel that if investment banks actually pitched the securities as cash-equivalents, the banks may be liable for losses and clients' inability to get their money back.[87] Investors are filing individual and class-action lawsuits claiming that the investment banks distorted the nature of the securities.[88]

Some suits claim investment banks misrepresented the liquidity and risks of auction-rate securities as cash-equivalents in press releases, monthly account statements, individual communications with investors and other investment guidance material.[89] In contrast, other suits allege investors never received any written information, not even a prospectus, at the time of sale.[90] This latter group of investors claim broker-dealers told them a prospectus was unnecessary because auction-rate securities were considered fail-proof secondary market sales.[91] Multiple investors are even claiming that when broker-dealers sold the securities there was no discussion of risk at all.[92] No matter the fact pattern, the common thread of the suits is that either visually, verbally or implicitly, investment firms misrepresented the securities as safe, liquid cash-equivalents that

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[84] *Lawmakers See Progress in Auction-Rate Securities*, INT'L HERALD TRIB., Sept. 18, 2008, http://www.iht.com/articles/ap/2008/09/18/business/NA-US-Auction-Securities-Hearing.php.
[85] Pressman, *supra* note 4.
[86] *Id.*
[87] Anderson & Bajaj, *supra* note 49.
[88] D'Silva et al., *supra* note 6.
[89] *Id.*
[90] Daniel C. Girard, *Billions to Answer For*, LEGAL TIMES, Vol. XXXI, No. 37, Sept. 15, 2008, http://www.girardgibbs.com/legaltimes.pdf.
[91] *Id.*
[92] Wasik, *supra* note 38.

were an attractive short-term alternative to money market investments.[93]

At first glance, one may wonder what role private civil suits play when states are already taking such an active public role in the debacle.[94] Despite the news of state-negotiated buybacks, such agreements do not include every type of purchaser of auction-rate securities.[95] Sales by "downstream" sellers (regional banks and brokerage firms that re-marketed the auction-rate securities but did not serve as underwriters or auction-mangers) are not included in the state-sponsored settlements.[96] Furthermore, the state buybacks are only attempting to refund investors their initial investment and not interest lost during the period that the money remained tied-up in the securities.[97]

In order to evaluate the potential success of such suits, it is necessary to understand how individual investors first decided to invest in the securities market. The issue ultimately comes down to the presence or lack of material disclosure by broker-dealers and investment banks.[98] Investment banks and broker-dealers did not have a legal responsibility to step in and prevent auctions from failing.[99] Most investors, however, probably did not know or understand that this would even be an issue.

If, however, investors were aware of banks' role in the auctions, investors may only have themselves to blame for having panicked and bolted for the exits.[100] In any market, panic exacerbates a downward spiral. By not showing up to auctions, investors dug their own grave. If, on the other hand, investors were truly unaware of the major role played by investment banks, they will likely succeed in their claims; currently, a multitude of investors claim to have not been told about the risks of the market. Furthermore, if the evidence does show that, while corporate clients unloaded their securities, broker-dealers counseled the investing public to purchase the securities, the situation moves into the realm of securities

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[93] William Kherkher LLP, http://auctionratesecuritieslawsuit.com/ (last visited Oct. 8, 2008).
[94] Girard, *supra* note 90.
[95] *Id.*
[96] *Id.*
[97] *Id.*
[98] Wasik, *supra* note 38.
[99] Johnston, *supra* note 1.
[100] *Id.*

fraud.[101] In this situation, the SEC needs to take a more aggressive stance on monitoring conflicts of interest and disclosure of financial advisor incentives and tighten regulations for market reports[102] in order to send a resounding message that this type of deceptive behavior will not be tolerated.[103]

F. Conclusion

The credit crunch took a major toll on the auction-rate securities market. Banks suffered significant capital losses while becoming over-saturated in the instruments. As investors lost confidence in the markets, the market for auction-rate securities effectively shut down. The good news for investors is that banks, albeit unwillingly, are beginning to take responsibility for the misleading information they provided to investors. Although much cash remains frozen in the now illiquid securities market, many investors have received at least a portion of their investments back.

The market lessons learned from this experience may be no different from those typically revealed when a market crashes, except one: if an instrument is long-term for one party, it must be long-term for the counter-party; any appearance to the contrary is likely only an illusion.[104]If an instrument appears to be too good to be true—long-term bonds issued at short-term rates while offering high yields and cash-like liquidity—it likely is.[105]

Amy Noblett[106]

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[101] Morgenson, *supra* note 60.
[102] Miga, *supra* note 45.
[103] Ellis, *supra* note 74.
[104] D'Silva et al., *supra* note 6.
[105] Posting of Alhambra Investments to http://alhambrablog.blogspot.com/2008/02/free-lunch.html (Feb. 22, 2008, 20:21 EST).
[106] Student, Boston University School of Law (J.D. 2009).

X. The Development of Covered Bonds in U.S. Markets

A. Introduction

As the U.S. faces a domestic credit crisis and a weakening economy, regulators and lenders are looking for ways to offer more loans to potential homebuyers and stabilize lending institutions.[1] In evaluating the problem, many tout covered bonds ("CBs") as a viable alternative, or at least a complement, to faltering mortgage-backed securities ("MBS").[2] At the same time, others dismiss CBs as a weak, ineffective substitute for the traditional MBS.[3] In evaluating this debate, it is necessary to trace the development of CBs in the U.S. and their potential for impacting current markets.

B. The Development of MBS as a Precursor to CBs

Mortgage-backed securitization involves the pooling of mortgages into a debt security that is isolated from the issuer and then sold to investors for an immediate capital return on the loans.[4] Prior to mortgage securitization, issuers did not receive capital from a mortgage until the borrower paid the mortgage in full.[5] Immediate capital returns allow the issuer to use that capital to offer more mortgages.[6] Thus, mortgage securitization creates a highly liquid product that increases loan availability for potential homebuyers.

Before securitization, investors traded unsecuritized mortgages on the secondary mortgage market.[7] Then, in 1970, the

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[1] Dep't of the Treasury, U.S. Department of the Treasury Best Practices for Residential Covered Bonds (July 2008) [hereinafter Best Practices], *available at* http://www.treas.gov/press/releases/reports/USCoveredBond BestPractices.pdf.
[2] *See id.*
[3] Julia Berris, *Undercover Agents*, THELAWYER.COM, Sept. 8, 2008, http://www.thelawyer.com/cgi-bin/item.cgi?ap=1&id=134434.
[4] *Preventing Abusive Lending While Preserving Access to Credit: Hearing Before the Subcomm. on Housing and Community Opportunity and Subcomm. on Financial Institutions and Consumer Credit*, 108th Cong. 69 (2003) (statement of Cameron L. Cowan, Partner, Orrick, Herrington, and Sutcliffe, LLP) [hereinafter *Hearings*], *full statement available at* http:// financialservices.house.gov/media/pdf/110503cc.pdf.
[5] *Id.* at 7.
[6] *Id.* at 6.
[7] *Id.* at 2.

Government National Mortgage Association, or "Ginnie Mae," securitized mortgages by pooling them and passing the principal and interest payments on to investors.[8] Because the issuer sold the entire mortgage to investors, the mortgages did not remain on the issuer's balance sheet, and they retained none of the loans' risk.[9] After Ginnie Mae's success in creating this profitable product, the federal government chartered Fannie Mae and Freddie Mac to both expand the market for investors and increase home ownership.[10]

These government-sponsored entities ("GSEs") dominated the early securitization market, and as a result, the market was relatively risk free.[11] But, as the demand for mortgages grew in the early 2000's, mortgage brokers began promoting interest-only mortgages, option adjustable-rate mortgages, and forty-year loans.[12] Many of these mortgages represent subprime debt because issuers marketed them towards borrowers with poor credit histories.[13] Non-agency lenders (e.g. mortgage brokers, banks, and homebuilders) then issued "private label" mortgage securities backed by this subprime debt.[14] The bonds had a higher rate of return than other securities, along with a higher insurance rating, which helped fuel the $11 trillion residential mortgage market.[15]

As mortgage holders defaulted across the nation, the value of investors' MBS decreased proportionally and, according to fair value accounting, institutional investors were forced to write down the losses.[16] Also because of the foreclosures, banks became reluctant to issue credit to homebuyers because of the lagging market for the ultimate securitized product.[17] Consequently, investors and regulators

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[8] *Id.*
[9] *Id.*
[10] *Id.*
[11] ALVIN L. ARNOLD, *Development of Securitization*, *in* REAL ESTATE TRANSACTIONS—STRUCTURE AND ANALYSIS WITH FORMS § 8:2.
[12] *Id.*
[13] John Waggoner & Matt Krantz, *Pricing Mortgage-backed Securities Will be Tough*, U.S.A. TODAY, 2008, http://www.usatoday.com/money/industries/banking/2008-09-23-toxic-paper-bailout_N.htm.
[14] ARNOLD, *supra* note 11.
[15] Best Practices, *supra* note 1, at 6.
[16] Tim Krumwiede et al., *Mortgage-Backed Securities and Fair-Value Accounting*, THE CPA JOURNAL, May 2008, http://www.nysscpa.org/cpajournal/2008/508/essentials/p30.htm.
[17] Best Practices, *supra* note 1, at 3.

are looking for a safer mortgage product and potential homebuyers are looking for ways to obtain credit.

C. CBs in the U.S. Market Compared to MBS

Some are looking toward CBs as a way to both create a profitable mortgage product without the risks associated with MBS and provide additional available credit to potential homeowners.[18] CBs are bank issued bonds backed by a specific pool of collateral that remain on the bank's balance sheet.[19] Currently, in the U.S., issuers are only offering CBs backed by residential mortgages.[20] CBs, while historically popular in Europe because of their ability to generate liquidity, have not been as popular in the U.S. because Fannie Mae and Freddie Mac have generated sufficient market liquidity and the FDIC has traditionally imposed strict commercial banking rules related to CBs.[21] Due in part to the current problems with Fannie and Freddie, and the FDIC's support of CBs, these instruments have a chance to gain exposure in the U.S.

Proponents of CBs claim they are a safer alternative to MBS with a higher chance of repayment because of two fundamental attributes.[22] First, as noted earlier, CBs remain on the issuer's balance sheet.[23] With MBS, the issuer sold the mortgage in full, thus removing the loan and its associated risk from the issuer's balance sheet.[24] Because CBs remain on the balance sheet, the mortgage only acts as collateral for the issuer's payments to the bondholder.[25] Therefore, if the asset fails, the bondholder still receives payments on the bond from the issuer.[26]

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[18] *See, e.g.*, *id.*
[19] *Id.* at 7.
[20] *Id.*
[21] *Id.* at 9; *see also* Patrick Temple-West & Peter Schroeder, *Housing: Dropping of AMT Expected to Draw Corporate Investors*, BOND BUYER (U.S.A.), July 30, 2008, *available at* 2008 WLNR 14133537; *Covered Bonds: What the Paulson Plan Means for You*, BUS. WK., July 30, 2008, *available at* http://www.businessweek.com/bwdaily/dnflash/content/jul2008/db20080729_334483_page_2.htm.
[22] Best Practices, *supra* note 1, at 7; *Firms Forming 'Covered Bonds' Practice Groups*, 30 NAT'L L.J. 51 (2008).
[23] Best Practices, *supra* note 1, at 7.
[24] Hearings, *supra* note 4, at 2.
[25] Best Practices, *supra* note 1, at 7.
[26] *See, e.g.*, *id.*

Second, because the bond remains on the issuer's balance sheet, the issuer must constantly replace underperforming mortgages with new collateral in order to generate enough capital to pay investors.[27] This is unlike MBS, which are paid solely by the cash flow from a static mortgage pool.[28] As a result, CBs are safer for investors than MBS because the issuer retains the risk and must constantly monitor collateral adequacy.[29] Due to these fundamental attributes of CBs, bondholders are doubly protected in the case of issuer default.[30] Investors have a claim against both the underlying asset and the issuer, whereas MBS bondholders have no claim against the issuer.[31]

In addition to their risk-averse attributes, regulators and issuers see CBs as a way to increase diversification of an issuer's funding sources.[32] With more funding, issuers can provide more credit to potential buyers.[33] In the wake of the credit crisis, banks are reluctant to offer mortgages because they will have difficulty selling them to wary investors; this in turn makes finding credit a struggle for potential homebuyers.[34] By providing CBs as an additional source of funding, issuers could ultimately reduce costs for potential homebuyers and provide more loans.

Despite these appealing attributes, CBs are not readily available in the U.S. After the FDIC and Treasury Department issued their support for CBs in July 2008, four large banks responded in kind and claimed that they would issue CBs in the near future.[35] Despite the initial enthusiasm, only two U.S. banks actually began to offer CBs: Bank of America and Washington Mutual.[36] After the recent dissolution of Washington Mutual, Bank of America is currently the sole issuer of CBs in the U.S. Even though Washington

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[27] Joe Adler, *Regulators Push Covered Bonds*, AM. BANKER, July 29, 2008, *available at* http://www.americanbanker.com/article.html?id=20080728NSU3IOJI.
[28] Best Practices, *supra* note 1, at 8.
[29] *See id.*
[30] *Treasury, Banks Promote 'Covered Bonds'*, WASH. POST, July 28, 2008, http://www.washingtonpost.com/wpdyn/content/article/2008/07/28/AR2008072801512_2.html; *see also* Best Practices, *supra* note 1, at 7.
[31] *Treasury, Banks Promote 'Covered Bonds'*, *supra* note 30.
[32] Best Practices, *supra* note 1, at 3.
[33] *See, e.g., id.*
[34] *Id.* at 3-4.
[35] Adler, *supra* note 27.
[36] *Id.*

Mutual dissolved, its CBs are still safe because J.P Morgan & Chase Company acquired all of that debt along with most of Washington Mutual's other assets.[37] Consequently, the small offering of CBs in the U.S is secure.

Given that CBs are so new to U.S. markets, the federal government has no formal legislation governing their distribution and handling.[38] The Treasury Department and FDIC have, however, released statements supporting CBs and addressing how they will supervise the market.[39] Most fundamentally, any issuer who wants to create a CB program must first receive permission from their primary federal regulator.[40] Beyond that, in a press release issued on July 28, 2008, the FDIC explained what actions it would take to secure CBs in the event an issuer entered into receivership or conservatorship and what types of CBs qualified for such treatment.[41] The policy also outlines under what circumstances a bondholder has expedited access to collateral should receivership or conservatorship be necessary.[42]

In a complementary document, the U.S. Treasury Department issued a series of "best practices" to help create a homogenous market.[43] The best practices are limited to CBs backed by collateral consisting of "high quality residential mortgage loans."[44] The scope is limited to specific CBs because CBs are currently designed only to address the problems in the housing market.[45] The limitation on collateral also allows the Treasury Department and the FDIC to create more funding for the housing

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[37] Jamie Mason, *Bankruptcy Likely for the Remains of WaMu*, DAILY DEAL, Sept. 29, 2008, *available at* 2008 WLNR 18372680.

[38] Best Practices, *supra* note 1, at 6.

[39] *See generally* Press Release, Fed. Deposit Ins. Corp., Covered Bond Policy Statement (July 28, 2008), *available at* http://www.fdic.gov/news/news/press/2008/pr08060a.html) [hereinafter FDIC Press Release]; *see generally* Best Practices, *supra* note 1.

[40] Best Practices, *supra* note 1, at 15.

[41] Secretary Paulson defined CBs as " . . . a non-deposit, recourse debt obligation of an [insured depository institution] with a term greater than one year and no more than thirty years, that is secured directly or indirectly by a pool of eligible mortgages or, not exceeding ten percent of the collateral, by AAA-rated mortgage bonds." FDIC Press Release, *supra* note 39.

[42] FDIC Press Release, *supra* note 39.

[43] Best Practices, *supra* note 1, at 6.

[44] *Id.*

[45] *See id.* at 3.

market while keeping the market small and thus more manageable.[46] Despite the limited scope of the market, the FDIC and Treasury Department have expressed hope that the market will grow to include other assets, and they have left the language of their respective statements open to such changes.[47]

D. The European CB Market

Even though the U.S. market is small, proponents often point to the thriving European market to show the potential CBs have for impacting U.S. markets.[48] CBs have a strong European history dating back to 1770.[49] European countries used CBs to finance agriculture, as well as residential and commercial real estate up to and through the twentieth century.[50] In 1995, CBs took on a new character in the German market with the introduction of the jumbo CB, which the government created to generate more market liquidity.[51] Since then, nearly every European country uses giant CBs to cover both commercial and residential mortgages, as well as public sector debt.[52] As a result, the CB market in Europe was estimated to be over EUR 2.11 trillion at the end of 2007.[53]

In recent weeks, faced with market instability similar to that of the United States, European governments have taken precautionary steps to insulate against bank failures and in turn protect CB holders.[54] In particular, the Irish government pledged to insure certain debt, including CBs, of six national banks.[55] Along with Ireland, banks in countries like Spain and England are facing funding difficulties.[56] Even countries unaffected by an internal real

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[46] *Id.* at 6.
[47] *Id.*; FDIC Press Release, *supra* note 39.
[48] *See, e.g.,* Best Practices, *supra* note 1, at 9.
[49] *Id.*
[50] *Id.*
[51] *Id.*
[52] *Id.*
[53] *Id.*
[54] *See, e.g.*, Simon Carswell, *Scheme Designed to Protect Banks First and Then Ordinary Depositors*, IRISH TIMES, Oct. 2, 2008, *available at* 2008 WLNR 18683159.
[55] *Id.*
[56] *Western Europe: Portugal - Country Report - An Uphill Climb For Credit In Portugal*, THE BANKER, Oct. 1, 2008, *available at* 2008 WLNR 18645508.

estate crisis, like Portugal, are nonetheless feeling the international pinch and are facing increased spreads in the CB market.[57] Despite suffering markets, as one analyst noted, the risk to the average taxpayer is still low because the CB system requires the issuer to provide adequate collateral at all times.[58] Consequently, despite the suffering bond market, the public has perhaps been less affected than its U.S. counterpart because the issuer retains the risk associated with CBs, whereas the risk of the MBS is passed on to the bondholder.

Even though the U.S is essentially adopting the CB from Europe, CBs will operate differently in American markets.[59] First, the CB market in Europe has a long and storied history.[60] In most European countries, the government has an established legislative framework to regulate the market.[61] While the U.S. hopes to provide a legislative framework, CBs in the U.S. presently have no legislative regulations.[62] Also in Europe, CB holders are the primary creditors if an issuer declares bankruptcy.[63] In the U.S., a bondholder is on par with other unsecured creditors in the event that an issuer cannot return the bond's full value.[64] Yet, in the U.S., the holder still has access to the underlying asset.[65] Ultimately, even though market regulation and handling of issuer default will differ, the fundamentals of European CBs will remain largely unchanged in the U.S.

E. Response to the Development of the CB Market and Its Potential for Success

Despite the federal government's support of CBs and their potential for helping mitigate the effects of the credit crisis, currently only Bank of America offers them domestically.[66] Two other operating banks have expressed interest in developing programs; however, as of October 2008, nothing has been done to effectuate

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[57] *Id.*
[58] Alan Ahearne, *Banks Must Pay Fair Price for Very Valuable Insurance Policy*, IRISH TIMES, Oct. 1, 2008, *available at* 2008 WLNR 18614238.
[59] Peter Page, *Firms Cover Themselves with 'Covered Bonds': New Area Meant to Rejuvenate Slumping Finance Practices*, 31 NAT'L L.J. 2 (2008).
[60] *Id.*
[61] Best Practices, *supra* note 1, at 9.
[62] *Id.* at 6.
[63] Page, *supra* note 59, at 2.
[64] Best Practices, *supra* note 1, at 7.
[65] *Id.*
[66] Adler, *supra* note 27.

that desire.[67] Also, according to the Treasury Department's Best Practices, Bank of America and any other potential issuer can only offer CBs as four percent of its liabilities.[68] Until issuers develop programs, CBs will probably not develop into a strong product in the U.S.

Even with a lack of issuers, presumed market interest in CBs has spawned a new area of development in law firms.[69] Several national law firms, in anticipation of a growing CB market, have developed practice groups dedicated to gaining expertise in the new field.[70] While some firms such remain skeptical about CB's ability to break into the U.S. market in a meaningful way, other firms seem to agree that by diversifying their knowledge base, they become more attractive to investors who are looking for safer investment strategies in the wake of the credit crisis.[71]

Some forward thinking proponents of CBs, however, are touting not just their place in the mortgage market but also in the development of American infrastructure.[72] In Europe, CBs backed by public sector debt are an integral part of infrastructure development.[73] Because issuers in the U.S. can only offer CBs backed by residential mortgages, however, any other collateral may sound promising, but has no practical basis in the current market.[74] Despite current impracticality, talk of innovative growth in an untapped market shows some interest in the development of CBs, particularly based on the European model.

F. Conclusion: Going Forward

Going forward, several active voices in the debate over CBs are not confident that these instruments will have a significant place in the securitization industry.[75] Many also recognize that CBs, while

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[67] *Id.*
[68] Best Practices, *supra* note 1, at 15.
[69] Berris, *supra* note 3.
[70] *Id.*
[71] *Id.*
[72] *See generally* Heidi Crebo-Rediker & Douglas Rediker, *Covered Bonds Can Rebuild America*, FORBES.COM, (July 28, 2008), http://www.forbes.com/2008/07/28/covered-bonds-infrastructure-oped-cx_her_dr_0728bonds.html.
[73] *Id.*
[74] *See* Best Practices, *supra* note 1, at 6; Adler, *supra* note 27.
[75] Temple-West & Schroeder, *supra* note 21.

maybe not a new force in the market, are certainly a less risky way to offer financing diversification and liquidity for issuers.[76] Perhaps the most obvious reason CBs will likely not take the place of MBS in American markets is that they are not lucrative enough.[77] Less risk means less reward. Even at a local level, it is unlikely that CBs will be a competitive force because of their taxable earnings.[78] In balancing the positive, risk averse attributes of CBs with the likelihood that they will develop popularity in the U.S., it seems unlikely that they will replace MBS as the primary securities product for mortgage financing but rather will become just another tool for funding diversification and improved liquidity in the mortgage market.

Haley McCole[79]

[76] *Id.*; *see also* Aleksandrs Rozens, *GSEs Still A Good Thing, Ranieri Says*, INV'T DEALER'S DIG., October 6, 2008, *available at* 2008 WLNR 18841659.
[77] Berris, *supra* note 3.
[78] Temple-West & Schroeder, *supra* note 21.
[79] Student, Boston University School of Law (J.D. 2010).

XI. The International Effects of the Credit Crisis

A. Introduction

As the world's largest economy in the midst of an historic credit crisis, the United States has made global headlines over the last year. As the crisis has unfolded in the U.S., a consensus has emerged within the economic and financial communities that the global economy will weaken.[1] Following the last domestic bubble burst in the tech industry, the international marketplace felt an immediate and noticeable impact from the resulting market turmoil in the United States. The global community will continue to feel the effects of the current credit crisis. Unlike the immediate and apparent international effects of the domestic tech bubble burst of the late '90's, however, the international effects of this economic crisis will be varied and in many instances not immediate, especially for the world's emerging economies.[2] While not completely immune to the credit crisis, emerging markets overall have been "fairly resilient to the global credit turmoil."[3] The discussion below will advance two arguments to help explain the resiliency of these emerging economies in the face of a global meltdown. On a broad scale, decoupling is one theory that could explain the varying effects of the crisis. This catchall approach, however, cannot explain the unique characteristics that have insulated some developing economies and left others highly exposed to the U.S. credit crunch. The varied effects of the credit crunch, therefore, warrant a closer examination of these markets.

B. Decoupling from the United States economy

While many have accepted globalization as the norm, the theory of "decoupling" posits that there are still "some apparent

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[1] John Lipsky, First Deputy Managing Dir., Int'l Monetary Fund ("IMF"), Speech at the Center for Strategic & International Studies: The Global Economy and Financial Turmoil (Sept.18, 2008).

[2] Donald L. Kohn, Vice Chairman, Bd. of Governors of the Fed. Reserve Sys., Speech at the Int'l Research Forum on Monetary Policy: Global Economic Integration and Decoupling (June 26, 2008).

[3] Peter Dattels et al., *Assessing Risks to Global Financial Stability,* in IMF GLOBAL FINANCIAL STABILITY REPORT: FINANCIAL STRESS AND DELEVERAGING, MACROFINANCIAL IMPLICATIONS AND POLICY 1.1 (Oct. 2008).

limitations on the effects of globalization" due to a greater heterogeneity between the business cycle of different countries.[4] The divergent effects of the U.S. credit crisis on emerging economies have challenged globalization as the default concept when examining global markets.[5] Further discussion will demonstrate why critics of the default globalization position invoke the decoupling hypothesis as an explanation of why emerging market economies have shown varying responses to the credit crisis.[6]

The last comparable global economic event caused by the United States was the tech bubble burst of 2001-2002, which was "experienced worldwide as a rapid, more-or-less synchronized downturn."[7] The U.S. gross domestic product ("GDP") grew an average 3.5 percent in 1999 and 2000, followed by a slowdown to 1.0 percent in 2001 and 2002 and then a recovery over 2003 and 2004.[8] Other industrialized countries experienced the same slowdown in average growth with a slower recovery, while emerging market growth fell from over 6.0 percent to 3.5 percent, followed by a recovery showing growth of over 6.5 percent.[9] Conversely, the credit crunch has hit domestic markets hardest and soonest with effects quickly spreading to other advanced economies, while there has been less of an impact seen on emerging market economies.[10] Leading credence to the arguments of those who believe in decoupling, economic growth in emerging markets is showing resiliency despite substantial slowdown in the U.S. and other European economies.[11]

However, others contend there has been no financial decoupling. Rather they believe there has been meaningful transmission of the credit crunch effects from the U.S. to other economies across the world.[12] For example, if the United States can

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[4] Michael Coote, *The Intriguing Hypothesis of Decoupling*, NAT'L. BUS. REV. (N. Z.), July 4, 2008.
[5] *Id.*
[6] *Id.*
[7] *Id.*
[8] Kohn, *supra* note 2.
[9] *Id.*
[10] Coote, *supra* note 4.
[11] Kohn, *supra* note 2.
[12] Nouriel Roubini, Speech at the IMF Seminar: The Risk of a U.S. Hard Landing and Implications for the Global Economy and Financial Markets (Sept. 13, 2007).

avoid a deep recession, perhaps growth conditions across the world are "sustained enough . . . [that] there may be a little bit of a slowdown but not a meaningful effect."[13] Some countries might in fact decouple from the slower growth of the U.S. economy. On the other hand, if the U.S enters a significant recession, the idea of decoupling is much less likely—there will be significant economic slowdown across trade and finance channels.[14] While decoupling might occur between industrialized and emerging market economies, the financial links between the U.S. and other industrial economies will remain strong.[15]

However, only time will reveal the full effects of the crisis on different economies abroad and whether they will track the trends of the U.S. economy. As many U.S. institutions have collapsed or required federal assistance, some believe the debate has shifted from whether emerging economies will decouple from the advanced economies to whether the overall global slowdown will be shallow and short, or deep and lengthy.[16] With the entire global economy slowing down, however, hope that emerging economies might be able to shelter themselves from the credit crunch has faltered.[17]

C. Regional Analysis

Aside from the broader possibility that emerging economies might decouple from more advanced economies, there are also country-specific effects to consider. In short, certain characteristics, such as a history of more conservative lending practices, have sheltered particular economies and regions from the credit crisis, while others, such as high rations of household debt to disposable income, have caused economies to feel the effects of the credit crisis more strongly.

Most countries experience counter-balancing effects from these elements, pulling the economic indicators in different directions. As such, just because one particular country has certain favorable characteristics sheltering it from the credit crisis does not necessarily mean its overall economic outlook will be brighter—another, more negative feature of the economy might be overriding

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[13] *Id.*
[14] *Id.*
[15] Kohn, *supra* note 2.
[16] Lipsky, *supra* note 1.
[17] Dattels et al., *supra* note 3.

any positive effects. In other words, there is no obvious inverse correlation between positive and negative characteristics, nor any indication that if any given country has one positive characteristic, other negative features are less likely to be found.

1. Western Europe

Across Europe, the impact of the credit crunch has been negative and immediate. The economies of Western European countries are closely tied to the United States. In fact, in many cases there has been direct European investment in the very mortgage-backed securities that instigated the credit crunch domestically.[18] Not surprisingly, the overall outlook for the Eurozone is poor.

Recent IMF figures for the entire Eurozone show an expected downturn of 1.3 percent in 2008, 0.2 percent in 2009.[19] There has been a lack of coherent, unified Eurozone response and many believe the European Central Bank does not have the option of cutting interest rates because the strong euro has caused high inflation across the Eurozone countries.[20]

First, countries experiencing the most significant effects are those with decreasing property values because of a highly leveraged real estate market. Spain in particular has been hit hard with property values down in some regions by as much as 60 percent.[21] The housing sector in the U.K. is also highly leveraged and is now undergoing the same process as the U.S. housing market.[22] Ireland's property prices are down 25 percent; Portugal's property prices are also down 19 percent.[23] Very low interest rates across the Eurozone,

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[18] Kohn, *supra* note 2.

[19] INTERNATIONAL MONETARY FUND, WORLD ECONOMIC OUTLOOK OCTOBER 2008: FINANCIAL STRESS, DOWNTURNS, AND RECOVERIES (Oct. 2008) [hereinafter WORLD ECONOMIC OUTLOOK], *available at* http://www.imf.org/external/pubs/ft/weo/2008/02/index.htm.

[20] Jessica Brown, *Where in the World to Beat the Credit Crunch?*, SUNDAY TIMES (U.K.), May 25, 2008, *available at* 2008 WLNR 9897588.

[21] *Id.* Spain is one of the countries that has "binged on easy credit" as the U.S. has done. *See* Emily Kaiser & Brian Love, *Effects of U.S. Credit Crisis Ripple Across the Atlantic*, INT'L HERALD TRIB., Aug. 7, 2008, http://www.iht.com/articles/2008/08/06/business/col07.php.

[22] *Global Financial Stability Report*, *supra* note 3. The U.K. has also been guilty of overindulging in the easy credit atmosphere. *See* Kaiser & Love, *supra* note 21.

[23] Brown, *supra* note 20

in existence for quite some time, are likely partially to blame for the housing bubble, as these lower interest rates have encouraged highly leveraged home purchasing.[24] Because of relying on high housing market prices, growing debt burdens have exposed banks and households, such as those in Spain, the U.K., Ireland, and Portugal, to great risk.[25]

Conversely, countries that have avoided a highly leveraged real estate market have not been hit as hard—Germany, for example, was initially proving surprisingly resilient to the credit crisis. Germany experienced less overall countrywide investment in the real estate market—about 80 percent of the population rents their homes.[26] German bank-held real estate portfolio values have held steady over the crisis period.[27] German bank price-to-book ratios have also been steady over the last year, suggesting investors believe them to be well capitalized.[28] However, Germany also has some of the strongest ties of any country to the U.S. and global economy. As the fallout effects from the U.S. and the U.K. begin to reach Germany, the IMF is predicting growth will fall from 2.5 percent in 2007 to 1.8 percent in 2008 and 0.0 percent in 2009.[29] The Netherlands probably falls into the same category as Germany; while there is economic slowdown predicted, this is not directly related to the fundamentals of the domestic economy. The IMF is expecting economic growth in the Netherlands to slow to 2.3 percent in 2008 (from a 3.5 percent growth rate in 2007), and it is predicting 1.0 percent growth in 2009.[30] Like Germany, property values and bank price to book ratios in the Netherlands have been holding steady.[31]

Another characteristic of faltering economies is a high ratio of household debt to disposable income. One factor influencing this ratio is the lack of conservatism in lending practices. For example, the lending practices typical in the U.K. have been similar to those in

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[24] *Id.*
[25] WORLD ECONOMIC OUTLOOK, *supra* note 19.
[26] Brown, *supra* note 20.
[27] Dattels et al., *supra* note 3.
[28] *Id.*
[29] WORLD ECONOMIC OUTLOOK, *supra* note 19.
[30] Catherine Hornby, *Dutch Finmin Sees Domino Effect from Credit Crisis*, Mar. 18 2008, REUTERS (U.K.), *available at* http://uk.reuters.com/article/rbssFinancialServicesAndRealEstateNews/idUKAAT00728220080318.
[31] Dattels et al., *supra* note 3. This suggests more market confidence in the level of capitalization of banks in the Netherlands.

the U.S.[32] Consequently, their growth predictions have dropped to 1.0 percent for 2008 and -0.1 percent in 2009, down from 3.0 percent in 2007.[33] Spain's debt to disposable income ratio is also higher than the average ratio for the Eurozone area and is closer to that of the U.S.[34] Their projected growth rates have taken a hard hit with a slowdown from 3.7 percent in 2007 to 1.4 percent in 2008 and -0.2 percent in 2009.[35]

Finally, countries such as Iceland and Belgium, with banks most heavily dependent on international funding, are the ones experiencing the most stress.[36] These banks relied on international financing to achieve the high leverage they wanted and had large holdings of U.S. dollar assets, further exposing them to the crisis.[37] Iceland's growth rates are predicted to be 0.3 percent in 2008 and -3.1 percent in 2009, down from 4.9 percent in 2007.

Across Western Europe, the countries most affected by the credit crisis are the ones with the strongest and most direct ties to the U.S. financial markets that have high household debt to disposable income ratios. Likewise, countries with highly leveraged real estate markets and falling housing prices and banks that are heavily dependent on international funding are feeling the credit crunch more so than others.

2. Emerging Europe, Commonwealth of Independent States (CIS)

The overall outlook for Eastern Europe is not as bleak as its Western European counterpart. The IMF predicts moderate growth across the rest of Emerging Europe.[38] The effects on this region are clearly secondary—not necessary related directly to the credit crunch, but rather the effects of the crunch in advanced Western economies that will in turn influence demand for commodities and

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[32] Kaiser & Love, *supra* note 19.
[33] Press Release, IMF, IMF Regional Economic Outlook for Europe Sees Slower Growth (Apr. 21, 2008) [hereinafter Economic Outlook for Europe].
[34] Dattels et al., *supra* note 3.
[35] WORLD ECONOMIC OUTLOOK, *supra* note 19.
[36] Dattels et al., *supra* note 3.
[37] *Id.*
[38] *Id.* Overall region growth was 5.7 percent in 2007, but predictions show growth to slow to 4.5 percent in 2008 and 3.4 percent in 2009. *See id.*

inflation rates.[39] Global commodity prices will also factor in to the well-being of this region over the next year.

An important economy in this region is Russia, which has held its own during this crisis. Russia's growth is expected to slow down from 7.0 percent in 2008 to 5.5 percent in 2009.[40] While partly due to increasing oil prices during the first half of 2008, others believe political changes might be having a positive effect as well.[41] In addition, output and energy exportation is projected to continue its solid growth, boosted by terms-of-trade gains.[42] Russia also has a large amount of foreign exchange reserves.[43] However, there are new uncertainties emerging in Russia that have resulted in some capital flight.[44] Overall, though, it appears Russia will be in a very favorable position over the next year if political changes stabilize and play out favorably, and if global demand for oil stays robust. Due to the gains in terms-of-trade as well as its foreign exchange reserves, Russia might still be better off than other oil-exporting countries that are suffering due to falling prices.

The growth rates for the rest of the Eastern European countries this will depend sharply on the degree of decreased demand for goods in Western Europe, and how inflation risks play out.[45] Some countries, such as Albania and Moldova, are actually expecting increased growth in 2008 and 2009, and some countries are expected to rebound in 2009, such as Macedonia, Serbia, and Turkey.[46] These countries have shown strong economic fundamentals and productivity gains, as well as less direct exposure to the damaging mortgage paper of the U.S.[47] However, the biggest hits in this region

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[39] *Id.*
[40] WORLD ECONOMIC OUTLOOK, *supra* note 19.
[41] For example, the investment community has "largely welcomed" the election of President Dmitry Medvedev, expecting the new administration to have a positive effect on businesses and an improved, favorable tax scheme for oil companies. *See* Brown, *supra* note 20.
[42] WORLD ECONOMIC OUTLOOK, *supra* note 19.
[43] Keith Bradsher & Heather Timmons, *Asian Savers get Case of the Jitters: Worries of Fallout from Wall St. Crisis,* INT'L HERALD TRIB., Sept. 25, 2008, *available at* https://www.istockanalyst.com/article/viewiStockNews+articleid_2650258~pageid_0.html.
[44] These include, for example, the recent conflict in Georgia and changes in the government. *See id.*
[45] WORLD ECONOMIC OUTLOOK, *supra* note 19.
[46] Economic Outlook for Europe, *supra* note 33.
[47] Dattels et al., *supra* note 3.

will be felt by the countries with high trade deficits and the risk of foreign capital flight, such as Bulgaria and Estonia.[48] This region has also seen soaring housing prices and increasing credit growth that has the potential for collapse, although so far these indicators continue to rise.[49] Overall, countries with stronger ties to Western Europe and U.S. banks that are dependent on international lending and Western European demand for exports will be most likely to struggle, while those with strong fundamentals and increasing domestic productivity gains will be the most sheltered.

3. Asia

Asian banks in general have not invested significantly in the U.S. mortgage-backed securities at the center of the credit crisis[50] but rather have generally utilized a more conservative lending philosophy, which is providing some buffer to the credit crunch.[51] Not surprisingly, only a very small amount of the total global write-downs has occurred at Asian banking institutions.[52] The overall question to be answered for this region is whether their conservative lending practices and high savings rates will be enough to counteract the effects of decreased global demand for exports.

As one of the major economies in this region, India is forecasting growth of 8.7 percent for 2008-2009.[53] India has an extremely young population demographic overall, as well as a very high savings ratio[54] and a large reserve of foreign exchange.[55] While these are all positive characteristics, there is also worry that India has been highly exposed to bad Western debt.[56] A lot of the country's government funding is done in the international market.[57] Overall however, the large amount of foreign reserves and the high savings

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[48] Mark Landler, *Global Race to Solve Credit Crisis,* INT'L HERALD TRIB. Oct. 8, 2008, *available at* http://www.istockanalyst.com/article/viewarticle+articleid_2689197.html.
[49] Dattels et al., *supra* note 3.
[50] WORLD ECONOMIC OUTLOOK, *supra* note 19.
[51] Brown, *supra* note 19.
[52] Dattels et al., *supra* note 3.
[53] Brown, *supra* note 20.
[54] *Id.*
[55] Bradsher & Timmons, *supra* note 43.
[56] *Id.*
[57] *Id.*

ratios might be enough to counteract any extraordinary exposure to bad Western debt.

China is not being hit as hard as Western Europe.[58] China did not have as much direct exposure to the problems of the U.S. because of their conservative lending practices and different regulatory structure. Banks in China, as in Asia in general, have followed the model of combining their commercial and investment banking, or focusing solely on commercial banking, as opposed to the U.S. model of allowing highly leveraged investment banks that has proven to be so treacherous.[59] In fact, China has become an attractive option for foreign direct investment within the last year as the full effects of the credit crises have emerged.[60] Investment growth has held up well, and domestic consumption has actually accelerated in the first half of 2008.[61]

However, China's economy relies heavily on exports of manufactured goods, and demand from the U.S. and Europe is dropping and will possibly continue to drop over the next year.[62] This poses a serious threat to China's longer-term growth. As so much of its economy relies on Western demand for exports, it is possible they could see stronger negative implications in the future.

Japan, unfortunately, has no doubt been adversely affected by the crisis; its economy has contracted in the second quarter.[63] Most of the growth in Japan has been driven by net exports rather than domestic demand due in part to a lack of substantial growth in Japanese real income and real wages.[64] As the global economy has slowed, demand for these exports has decreased, leaving Japan in the second quarter of 2008 with a 3 percent contraction in the quarter-over-quarter annualized growth rate.[65] The Japanese stock market has also taken a hit as investors grow more concerned about weak growth

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[58] WORLD ECONOMIC OUTLOOK, *supra* note 19.
[59] *Id.*
[60] *China Most "Attractive" Destination for FDI*, CHINA DAILY, Sept. 25, 2008, *available at* http://www.chinadaily.com.cn/china/2008-09/25/content_7056886.htm.
[61] WORLD ECONOMIC OUTLOOK, *supra* note 19.
[62] *Id.*
[63] Martin Fackler, *During the Crisis, Japan Feels Like an Island of Calm*, INT'L HERALD TRIB., Sept. 21, 2008, *available at* http://www.iht.com/articles/2008/09/21/business/yen.php.
[64] Roubini, *supra* note 12.
[65] WORLD ECONOMIC OUTLOOK, *supra* note 19.

outlooks.[66] However, the giant Japanese banks have stood strong.[67] Some speculate this is because Japanese banks learned their lesson in the 1990's when they became burdened with bad loans related to real estate, resulting in a cautious outlook that helped the country avoid too much exposure to the risky subprime loans involved in the U.S. crisis.[68] The IMF predicts subprime-related losses for Japanese finance companies to total just $8 billion, which is not overly worrisome considering Japan is the world's second-largest economy and global subprime-related losses are predicted to top $1 trillion.[69]

4. Latin America

Overall, the Latin American countries have, thus far, held up well in the face of increasingly troubled U.S. and European markets. Baseline forecasts predict a modest slowing of regional growth to 4.6 percent in 2008 and to 3.2 percent in 2009.[70]

One reason cited for only modest slowdown in this region is the lack of substantial exposure to the subprime-related credit products that have been the downfall of the U.S. and European markets.[71] Like Japan, more stringent regulatory frameworks have made it difficult for banks to buy these contaminated products and to accumulate the degree of off-balance sheet exposures that have proved so troubling for U.S. banking institutions.[72] Furthermore, corporations in Latin America are relying, as they have historically, on retained earnings for much of their financing needs.[73] Some attribute this particular corporate characteristic in the region to the fact that corporations in Latin America are "used to operating in an environment of macroeconomic volatility."[74] Moreover, certain countries such as Argentina, Columbia, Panama, and Peru are beginning to "show the sort of economic dynamism more usually

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[66] *Id.*
[67] Fackler, *supra* note 63.
[68] *Id.*
[69] *Id.*
[70] Anoop Singh, Dir. of W. Hemisphere Dep't, IMF, Speech at the IMF's Conference on the Euro: Global Implications and Relevance for Latin America (Mar. 17, 2008).
[71] *Id*.
[72] *Id.*
[73] *Id.*
[74] *Id.*

attributed to India and China."[75] Finally, domestic demand has held up well, and the IMF cites gains for commodity exporters because of more favorable terms-of-trade.[76]

Of particular concern for the Latin American region, however, is the broad influence of global commodity prices on the health of this economic region. The reason South America has not experienced the full impact of the credit crunch is in part because the cost of commodities in general has been high.[77] As commodity prices fall globally due to an expectation of decreased demand over the next year, the negative repercussions for Latin American economies will become more apparent. However, some cite the possibility of low interest rates and a depreciating U.S. dollar as counter effects that could continue to buoy commodity prices over the next year even as developed market demand slows.[78] The pivotal question for this region moving forward will be the degree to which global commodity prices remain stable. If prices remain stable, the favorable regulatory and economic policy changes combined with historically conservative business practices will likely shelter this region from the worst effects of the credit crisis.

5. Africa

Overall, African markets have not seen very much direct exposure to the contaminated commercial paper of the Western markets.[79] Consequently, the economic outlook over the next few years of certain African countries is surprisingly favorable. Growth for this region as a whole is expected to decline from 6.3 percent in 2007 to 5.9 percent in 2008 and rebound to 6.0 percent in 2009.[80] Of course, there is a large degree of variation across the continent, and much of it depends on whether the countries are exporting or importing oil, food, and other natural resources.[81]

In addition to less direct exposure to Western financial markets, other factors could help shelter Africa from the crisis: the emerging middle class, as local demand is driving growth in African

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[75] Brown, *supra* note 20.
[76] WORLD ECONOMIC OUTLOOK, *supra* note 19.
[77] Brown, *supra* note 20.
[78] Singh, *supra* note 70.
[79] Brown, *supra* note 20.
[80] WORLD ECONOMIC OUTLOOK, *supra* note 19.
[81] *Id.*

company earnings,[82] and the broad ranges of natural resources that have not yet been fully utilized.[83] Again, slowing global demand for these resources might limit their sheltering effects. The managing director of the IMF, however, expects commodity prices to stay at much higher levels than in the past, although he cites higher sensitivity to global demand and supply expectations.[84] In addition, improved terms-of-trade will also benefit many exporting countries.[85] Oil importing countries, however, will likely suffer more.[86] Finally, rising food prices will have a much stronger impact across the region as many countries depend greatly on food imports.[87]

In this region, as in Latin America, countries with the ability to take advantage of natural resources combined with the ability to rely more heavily on domestic demand will be in a better position than oil and food importing countries.

6. Australia

In general, Australia seems to be in a much better position than many developed economies, in part due to its abundance of natural resources and strong regulatory oversight and conservative lending practices.[88] In particular, investment in mining projects has risen to record levels.[89] If speculation that the demand for Australian resources will continue to stay strong is misplaced, however, the credit crunch may invade Australia to a greater degree. While its natural resources, regulatory oversight and conservative lending practices have thus far shielded Australia from the credit crunch, only time will tell whether Australia will be able to shield itself in the long term, as effects on export demand become more apparent.

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[82] Brown, *supra* note 20.
[83] *Id.*
[84] *Quarterly Market Review: International Monetary Fund View,* FUND STRATEGY, Sept. 22, 2008, *available at* 2008 WLNR 18063260.
[85] WORLD ECONOMIC OUTLOOK, *supra* note 19.
[86] *Id.*
[87] *Id.*
[88] Brown, *supra* note 20.
[89] *Id.*

D. Conclusion

There is no doubt that the international community will feel the effects of the credit crunch as economic growth slows. Emerging markets generally have fared better than their industrial counterparts during this crisis due to their weaker direct ties to the financial markets of the U.S. and Western Europe. Possibly this decoupling will continue and allow emerging markets to remain steady with higher growth rates. The experiences of countries in different regions demonstrates that conservative lending practices, high savings ratios, reliance on domestic as opposed to international demand, and a strong regulatory framework pay off in times of financial crisis. Some of these "best practices" may be implemented in the U.S. to avoid a similar crisis in the future.

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XII. The "Too Big to Fail" Doctrine and the Credit Crisis

A. Introduction

In 2008, governmental agencies intervened to rescue failing financial institutions at an unprecedented pace. Critics have argued that such rescues are intertwined with the idea of a "Too Big to Fail" ("TBTF") policy.[1] The TBTF theory refers to the inchoate public policy notion that certain institutions are so large or so complex that the government will intervene and prevent their failure by protecting uninsured creditors from their losses[2] due to the perceived systemic risk presented by the organization's failure. [3] There is no set of cohesive principles used by regulators in deciding what entity is actually "too big to fail."

B. Laws Related to Failing Financial Institutions

1. Federal Deposit Insurance Act

The Federal Deposit Insurance Act of 1950[4] ("FDIA") includes the basic authority for the operation of the Federal Deposit Insurance Corporation ("FDIC").[5] An important provision in the FDIA was § 13(c)(2), which gave the FDIC authority to "bail out," or supply financial support to, a bank when certain conditions were met.[6] The standards set by this "essentiality doctrine"[7] required a finding that (1) the bank is in danger of closing and (2) the operation of the bank is essential to the community.[8] Neither the law nor the

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[1] Michael Sisk, *Too Big to Fail?*, U.S. BANKER, Nov. 2008, at 14.
[2] GARY STERN & RON FELDMAN, TOO BIG TO FAIL: THE HAZARDS OF BANK BAILOUTS 1 (2004).
[3] *Id.*
[4] Federal Deposit Insurance Act of 1950, P.L. 81-797, 64 Stat. 873 (1950).
[5] Fed. Deposit Ins. Corp., *Important Banking Regulation*, http://www.fdic.gov/regulations/laws/important/index.html (last visited Oct. 29, 2008).
[6] IRVINE H. SPRAGUE, BAILOUT: AN INSIDER'S ACCOUNT OF BANK FAILURES AND RESCUES 27-29 (1986).
[7] *Id.* at 87.
[8] Federal Deposit Insurance Act of 1950, §13(c), 64 Stat. 873, 888-89 (current version at 12 U.S.C.S. §1823 (2008)) ("[W]hen the Corporation has determined that an insured bank *is in danger of closing*, in order to prevent such closing, the Corporation, in the *discretion of its Board of Directors*, is authorized to make loans to, or purchase the assets of, or make

legislative history provided any insight as to how these findings should be made, nor did they include the definitions of community or adequate banking services.[9] Although Congress might have in intended the word "community" be construed in a geographical sense, the word took on a broader meaning later: groups or constituencies that have common interests.[10] In practice, the FDIC was reluctant in making a finding of essentiality unless there was a "clear and present danger to the nation's financial system."[11] The law gave the FDIC Board of Directors discretionary authority to make the finding.[12] However, the statute required that at least two out of the three of the Directors of the FDIC agreed on the findings and the action to pursue.[13]

2. The Federal Deposit Insurance Corporation Improvement Act

In 1991, Congress enacted the Federal Deposit Insurance Corporation Improvement Act[14] ("FDICIA") which included provisions to address the TBTF problem.[15] Until 1991, the FDIC was required to estimate the cost of a payoff and liquidation as the standard of comparison and could adopt an alternative resolution if the alternative was expected to be less costly than the standard.[16] However, when the FDIC operated under the essentiality provision,

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deposits in, such insured bank, upon such terms and conditions as the Board of Directors may prescribe, when in the *opinion of the Board of Directors* the continued operation of such bank is *essential to provide adequate banking service in the community*."(emphasis added)).

[9] *Id.*

[10] SPRAGUE, *supra* note 7 at 43.

[11] *Id.* at 28-29.

[12] *Id.*

[13] *Id.*

[14] Federal Deposit Insurance Corporation Improvement Act of 1991, P.L. 102-242, 105 Stat. 2236 (1991).

[15] Frederic S. Mishkin, *How Big a Problem is Too Big to Fail? A Review of Gary Stern and Ron Feldman's Too Big to Fail: The Hazards of Bank Bailouts*, 44 J. ECON. LIT. 988, 994 (2006).

[16] Fed. Deposit Ins. Corp., *History of the Eighties—Lessons for the Future*, 235, 244 (Dec. 1997), http://www.fdic.gov/bank/historical/history/235_258.pdf#search=%27Continental%20Illinois%27 [hereinafter *FDIC History*].

cost considerations could be disregarded.[17] FDICIA amended § 13(c)(2) requiring regulators to close banks using the least-cost procedure, thus prohibiting the FDIC from granting open-bank assistance to a failing bank unless its action was cheaper than a closed-bank resolution.[18]

However, an exception to the least-cost procedure dictates that if the least-cost resolution will present "serious adverse effects on economic conditions or financial stability," then the FDIC can follow a different action to protect the uninsured and thereby ameliorate the impact of bank failure on the economy.[19] The FDICIA established a procedure for taking such action. First, at least two-thirds of the FDIC Board must agree to make a written recommendation to the Secretary of the Treasury that an exception to the least-cost procedure is warranted. Second, at least two-thirds of the Federal Reserve Board must also agree to make the same written recommendation to the Secretary of the Treasury. Finally, upon receiving the recommendation, the Secretary of the Treasury, in consultation with the President of the United States, must determine that if the least-cost procedure were administered then there would be "serious adverse effects on economic conditions or financial stability."[20] The FDIC is allowed to use the Deposit Insurance Fund for an action under the systemic risk exception.[21] Nevertheless, the FDIC can expeditiously recover the loss to the Fund, if any, from protected insured claimants.[22]

3. The Federal Reserve Act

The Federal Reserve Act[23] ("FRA") contains, *inter alia*, a description of all the powers awarded to Federal Reserve Banks.

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[17] *Id.*

[18] *Id.*

[19] 12 U.S.C.S. § 1823(c)(4)(G)(i) (2008). *See also* STERN & FELDMAN, *supra* note 2 at 78.

[20] 12 U.S.C.S. §1823(c)(4)(G)(i).

[21] *Id.* 12 U.S.C.S. §1823(c)(4)(E) establishes that the Deposit Insurance Fund cannot be used in connection with an insured depository institution that would have the effect of increasing losses to the Deposit Insurance Fund by protecting the depositors or creditors. However, 12 U.S.C.S. §1823(c)(4)(G) is outside that limitation.

[22] 12 U.S.C.S. §1823(c)(4)(G)(ii) (stating that the recovery must be made according to an assessment on the total assets of all insured banks).

[23] Federal Reserve Act of 1913, 12 U.S.C. § 221 (2000).

Traditionally, one of these powers has been to lend to banks in need through a "discount window." In the past, the Fed only loaned to commercial banks.[24] However, a 1932 road construction bill contained an amendment to the FRA that allowed the Federal Reserve Bank's discount window to be accessible to other financial institutions beyond commercial banks.[25] The process outlined by section 13(3) of the FRA requires (1) the Board of Governors of the Federal Reserve ("Fed") to determine that the circumstances are unusual and exigent; (2) evidence that no other banking institution is able to secure the credit; and (3) at least five out of seven members of the Board of Governors of the Fed gives authorization. [26]

4. Housing and Economic Recovery Act

On July 30, 2008, in response to the subprime mortgage crisis,[27] the Housing and Economic Recovery Act of 2008 ("HERA")[28] was enacted. One of the primary purposes of HERA was to reinforce and improve the regulation of the housing government-sponsored enterprises ("GSEs"), Freddie Mac and Fannie Mae, and

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[24] David Fettig, Fed. Reserve Bank of Minneapolis, *Lender of More than Last Resort* (Dec. 2002), *available at* http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=3392.

[25] 12 U.S.C.S. § 343 (2008). *See also* Walker F. Todd, Am. Inst. for Econ. Research, *The Bear Stearns Rescue and Emergency Credit for Investment Banks*, Aug. 11, 2008, *available at* http://www.aier.org/research/commentaries/445-the-bear-stearns-rescue-and-emergency-credit-for-investment-banks.

[26] 12 U.S.C.S. § 343 ("In unusual and exigent circumstances, the Board of Governors of the Federal Reserve System, by the affirmative vote of not less than five members, may authorize any Federal reserve bank . . . to discount for any individual, partnership, or corporation, notes, drafts, and bills of exchange . . . *[p]rovided*, [t]hat before discounting . . . the Federal reserve bank shall obtain evidence that such individual, partnership, or corporation is unable to secure adequate credit accommodations from other banking institutions. . . .").

[27] *See generally Developments in Banking and Financial Law—The Subprime Mortgage Crisis*, 27 REV. BANKING AND FIN. L. 1 (2008).

[28] Housing Economic Recovery Act of 2008, Pub. L. No. 110- 289, 122 Stat. 2654 (2008).

the Federal Home Loan Banks.[29] To accomplish this goal, HERA established a new, independent regulator: the Federal Housing Finance Agency ("FHFA") and phased out the regulator of Fannie Mae and Freddie Mac, the Office of Federal Housing Enterprise Oversight, and the regulator of the Federal Home Loan Banks, the Federal Housing Finance Board.[30] Under the HERA, the FHFA can exercise control over "critically undercapitalized regulated entities" and place the entity in conservatorship or receivership.[31] The Director of the FHFA has the discretion to appoint the FHFA as the conservator or receiver of one of these GSEs.[32] HERA lists twelve different grounds for making the discretionary appointment.[33] The decision to place an entity under receivership or conservatorship is only reviewable by a court.[34] Within thirty days of the Director's decision, the entity can "bring an action in the United States district court for the judicial district in which the home office of such regulated entity is located, or in the United States District Court for the District of Columbia" to require the FHFA to remove itself as conservator or receiver.[35] The court has the power to dismiss the action or to direct the FHFA to remove itself from the position of conservator or receiver. [36]

In addition, HERA granted the Secretary of the Treasury temporary authority through the end of 2009 to buy obligations and other securities issued by GSEs, as long as he made a determination

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[29] U.S. Senate, *Summary of the Housing and Economic Recovery Act of 2008,* http://banking.senate.gov/public/_files/HousingandEconomicRecoveryActSummary.pdf (last viewed Oct. 29, 2008).
[30] *Id.*
[31] Housing Economic Recovery Act of 2008 § 1145 (amending Section 1367 of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, 12 U.S.C. § 4617 (2000)).
[32] *Id.*
[33] *Id.* § 1145(a)(2). The twelve grounds are insufficient assets, substantial dissipation, unsafe and unsound conditions, violation of cease and desist orders, concealment of records, inability to meet obligations, capital losses, violations of the law, consent, under capitalization, critical under capitalization, and money laundering.
[34] *Id.*
[35] *Id.*
[36] *Id.*

of emergency.[37] To make a finding of emergency, the Secretary of Treasury needs to determine that the actions are necessary to "(i) provide stability to financial markets, (ii) prevent disruptions in the availability of mortgage finance; and (iii) protect the taxpayer."[38] HERA does not limit the amount that the Treasury can purchase.[39]

5. The Emergency Economic Stabilization Act

On October 3, 2008, the President signed into law the Emergency Economic Stabilization Act of 2008[40] ("EESA"). The EESA was a radical move by the government of the United States to stabilize the financial system and protect the economic welfare of Americans.[41] EESA contains a provision for the Troubled Assets Relief Program[42] ("TARP"). EESA gave the Secretary of the Treasury not only authority to develop and implement the program but also discretion to determine the terms and conditions of the program.[43] However, the provision requires that the Secretary of the Treasury consult with the Fed, the FDIC, the Comptroller of the Currency, the Director of the Office of Thrift Supervision, the Chairman of the National Credit Union Administration, and the Secretary of Housing and Urban Development as he exercises his authority under TARP.[44] EESA also authorizes the Secretary of the Treasury to take any action he considers necessary to perform his

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[37] *Id.* §1117 (amending Section 304 of the Federal National Mortgage Association Charter Act (12 U.S.C. § 1719 (2000)) and Section 306 of the Federal Home Loan Mortgage Corporation Act (12 U.S.C. § 1455 (2000)).
[38] *Id.*
[39] *Id.*
[40] Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 101(a), 122 Stat. 3765 (2008) (granting authority to the Secretary of the Treasury "to purchase, and to make and fund commitments to purchase, troubled assets from any financial institution, on such terms and conditions as are determined by the Secretary, and in accordance with this Act and the policies and procedures developed and published by the Secretary."). *See also* David M. Herszenhorn, *Bailout Plan Wins Approval; Democrats Vow Tighter Rules*, N.Y. TIMES, Oct. 4, 2008, at A1.
[41] Press Release, U.S. Dep't of Treasury (Oct. 3, 2008), *available at* http://treas.gov/press/releases/hp1175.htm.
[42] Emergency Economic Stabilization Act of 2008, § 101(a).
[43] *Id.*
[44] *Id.* at § 101(b).

authorities under EESA.[45] Finally, the act establishes that the Secretary of the Treasury must take the necessary steps to prevent unjust enrichment of participating institutions.[46]

C. Application of the Law

Laws discussed above relate to the powers conferred to governmental agencies to respond to situations in which a financial institution's failure poses a large risk to the economy. Over the last 25 years, the TBTF doctrine and these laws, as they have been promulgated, have contributed to a complex history of regulatory intervention in the realm of potential financial institution failure.

1. Continental Bank of Illinois and FDICA

The most prominent case of the FDIC acting under Section 13(c)(2) of FDIA is that of Continental Bank of Illinois ("Continental") in 1984.[47] Continental, a leading commercial lender, became insolvent due to a run of wholesale deposits from around the world.[48] Afraid of the consequences that the failure of Continental could cause in the entire banking system, the FDIC decided to intervene. Addressing the short-term problem, the FDIC provided a $2 billion subordinated loan, which could be called at any time with the Board's approval.[49] The FDIC granted the loan under Section 13(c)(2).[50] The FDIC had made a finding of essentiality, but the press release did not mention this.[51] Furthermore, the FDIC granted 100% protection to all depositors (including uninsured) and all general creditors.[52] Meanwhile, the FDIC unsuccessfully searched for banks interested in acquiring Continental.[53]

The FDIC decided to act under Section 13(c)(2) of FDIA and provide a capital and liquidity supplement, or "bailout."[54] The bailout

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[45] *Id.* at § 101(c).
[46] *Id.* at § 101(e).
[47] *See generally* SPRAGUE, *supra* note 6, at 149-228.
[48] *Id.* at 149.
[49] *Id.* at 159.
[50] *Id.* at 161.
[51] *Id.* at 162.
[52] *Id.*
[53] FDIC History, *supra* note 16, at 244; SPRAGUE, *supra* note 6 at 170.
[54] FDIC History, *supra* note 16, at 244.

package consisted of FDIC purchasing the bad loans and injecting new capital into the bank.[55] The FDIC purchased $4.5 billion in bad loans for $3.5 billion; Continental continued to manage those loans under a servicing contract.[56] The failed bank had to write-off the $1 billion loss for the loan transfer, but the FDIC also acquired $1 billion of preferred non-voting stock in Continental's newly created holding company to replace the loss.[57] Continental's top management and Board of Directors were removed and replaced by officers chosen by the FDIC.[58] The actions under Section 1(2) protected both depositors (including uninsured) and creditors.

On September 19, 1984, the House Banking Committee held a hearing about the rescue of Continental.[59] During the hearing, Comptroller of the Currency, Todd Conover, stated that the federal government would not allow any of the eleven largest banks in the United States to fail.[60] A response of one of the Committee's members was that the government was thereby creating a new bank category: the "too big to fail" bank.[61] Continental's bailout coupled with the statements made during the hearing confirmed investors' understanding that the government would bail out creditors (and depositors) of a TBTF institution.

2. Bear Stearns and the FRA

In March of 2008, the government faced the first major disaster of the subprime mortgage market crisis: Bear Stearns ("Bear"), a large investment bank, faced collapse.[62] Bear's possible failure did not call for the FDIC's intervention because unlike Continental Bank, Bear was not under the protection of the FDIC. However, the Fed decided to act. Its first move was to provide Bear with a 28-day emergency loan through commercial bank JP

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[55] SPRAGUE, *supra* note 6, at 209.
[56] FDIC History, *supra* note 16, at 244.
[57] SPRAGUE, *supra* note 6, at 209-210.
[58] *Id.* at 210.
[59] Tim Carrington, *U.S. Won't Let 11 Biggest Bank In Nation Fail*, WALL ST. J., Sept. 20, 1984, at A2.
[60] *Id.*
[61] *Id.*
[62] Samar Srivastava and Jeff Kearns, *Bear Stearns Falls to 5-Year Low on Capital Concern*, BLOOMBERG, Mar. 13, 2008 *available at* http:// www.bloomberg.com/apps/news?pid=newsarchive&sid=a69chRKal0mo.

Morgan.[63] Later that month, the Fed relied on Section 13(3)[64] of the FRA to bailout Bear Sterns by providing a loan through JP Morgan, who was buying Bear, of almost $30 billion.[65] It was only the second time the Fed relied on Section 13(3) in 75 years.[66] Following the procedure stated in the statute, the Fed determined that the circumstances were "unusual and exigent" in light of the weak financial markets and the interconnectedness of Bear Stearns. [67] In addition, the Fed concluded that Bear Sterns was "unable to secure adequate credit accommodations elsewhere."[68] The four members present at the meeting unanimously approved the loan.[69]

3. Lehman Brothers and Ch. 11 Bankruptcy

The next challenge government faced was Lehman Brothers' ("Lehman") collapse.[70] Lehman, another large investment bank, had substantial investments in real-estate holdings that had declined in value, and the firm could not raise new capital to offset these

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[63] Stephen Bernard, *JPMorgan Chase Funding Bear Stearns,* INT'L. BUS. TIMES, Mar. 14, 2008, *available at* http://www.ibtimes.com/articles/20080314/jpmorgan-chase-funding-bear-stearns.htm.

[64] *See supra* note 25-26 and accompanying text.

[65] Todd, *supra* note 25.

[66] David Fettig, Fed. Reserve Bank of Minneapolis, *The History of a Powerful Paragraph* (June 2008) *available at* http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=3485.

[67] *Turmoil in U.S. Credit Markets: Examining the recent action of federal financial regulators: Hearing before the Senate Banking, Housing and Urban Affairs Committee*, 110th Cong. 2 (2008) (statement of Ben Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys.).

[68] Bd. of Governors of the Fed. Reserve Sys., Minutes (Mar. 14, 2008), *available at* http://www.federalreserve.gov/newsevents/press/other/other20080627a1.pdf.

[69] *Id.* (clarifying that even though the statute requires at least five members to consent, only four members of the Board were present at the meeting where the action was authorized). According to the minutes of the meeting, the FRA requires that when less than five members are present the vote must be unanimous and the action must be necessary before the other member will be available. *See* Federal Reserve Act § 11(r), 12 U.S.C. § 248(r) (2006).

[70] Jenny Anderson and Andrew Ross Sorkin, *Lehman Said to be Looking for a Buyer as Pressure Builds*, N.Y. TIMES, Sept. 10, 2008, at A1.

investment losses.[71] As Lehman's situation quickly worsened, the expectations were that Lehman would receive government assistance.[72] Despite of all the expectations, the government decided not to step in to save Lehman.[73] Lehman filed for bankruptcy on September 15, 2008.[74]

Henry Paulson, Secretary of the Treasury, stated that bailing-out Lehman was not an option he considered because of the "moral hazard" issue, the theory stating that entities that are protected from the consequences of risky behavior tend to engage in such behavior more frequently.[75] One market commentator seemed to believe that the circumstances were different for Lehman, as the bank "had time to sell assets and raise capital" and the discount window was available for them, unlike for Bear.[76] In retrospect, Paulson maintained that letting Lehman fail was the right decision, especially because there was no buyer for Lehman.[77]

4. AIG and the FRA

Days after Lehman Brothers' bankruptcy filing, the Fed faced another failing institution: American International Group

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[71] Rachel Beck, *All Business: Lehman Shows Few are Too Big to Fail*, INT'L. BUS. TIMES, Sept. 16, 2008, *available at* http://www.ibtimes.com/articles/20080916/all-business-lehman-shows-few-are-too-big-to-fail.htm (describing that expectations came from the fact that Lehman was larger than Bear, and Lehman was more involved in the mortgage-backed securities market which could result in more chaos than Bear's collapse).

[72] Paul R. La Monica, *Lehman: Too Big to Fail?*, CNNMONEY.COM, Sept. 10, 2008, *available at* http:// money.cnn.com/2008/09/10/markets/thebuzz/.

[73] Andrew Ross Sorkin, *Bids to Halt Financial Crisis Reshape Landscape of Wall St.*, N.Y. TIMES, Sept. 14, 2008, at A1..

[74] Press Release, Lehman Bros. Holdings, Lehman Brothers Holdings Inc. Announces It Intends to File Chapter 11 Bankruptcy Petition (Sept. 15, 2008), http://www.lehman.com/press/pdf_2008/091508_lbhi_chapter11_announce.pdf.

[75] Martin Crutsinger, *Paulson Says Lehman Bailout was Never an Option*, Associated Press, INT'L. HERALD TRIB., Sept. 15, 2008, available at http://www.iht.com/articles/ap/2008/09/15/business/NA-US-Paulson-Markets.php.

[76] Beck, *supra* note 71.

[77] *Paulson says Global Markets Remain Strained*, Associated Press, INT'L. HERALD TRIB., Oct. 8, 2008, *available at* http://www.iht.com/articles/ap/2008/10/08/business/NA-US-Meltdown-Paulson .php.

(AIG).[78] AIG, the largest insurer in the world, faced difficulty when their credit ratings were downgraded to the point where they needed to post $14 billion more in their credit-default swaps collateral overnight.[79] On September 16, 2008, again relying on Section 13(3) of the FRA, the Fed authorized the Federal Reserve Bank of New York to create a line of credit of up to $85 billion for AIG.[80] The loan was collateralized by AIG's assets and the assets of "its primary non-regulated subsidiaries."[81] In exchange for the loan, the government received a 79.9 percent equity interest in AIG and the "right to veto the payment of dividends to common and preferred shareholders."[82] Federal Reserve Chairman Ben Bernanke justified the actions, stating that the "disorderly failure of AIG would have severely threatened global financial stability and the performance of the U.S. economy."[83] Nothing further was mentioned as to compliance with any of the requirements of Section 13(3). On October 8, 2008, the Fed relied again in Section 13(3) of the FRA and authorized the Federal Reserve Bank of New York to "borrow up to $37.8 billion in investment-grade, fixed-income securities from AIG in return for cash collateral."[84] The Fed did not reveal anything as to the

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[78] Tami Luhby, *Fed in AIG Rescue: $85B loan*, CNNMONEY.COM, Sep. 17, 2008, http://money.cnn.com//2008/09/16/news/companies/AIG/index.htm (stating that AIG's assets amount to $1.1 trillion, with more than 70 million customers including many of the world's biggest and most important financial firms).

[79] Andy Serwer and Allan Sloan, *The Price of Greed*, TIME, Sept. 29, 2008 at 32, 35.

[80] Edmund L. Andrews et al., *Fed's $85 Billion Loan Rescues Insurer*, N.Y. TIMES, Sept. 16, 2008, *available at* http://www.nytimes.com/2008/09/17/business/17insure.html.

[81] Press Release, Bd. of Governors of the Fed. Reserve Sys. (Sept. 16, 2008), *available at* http://www.federalreserve.gov/newsevents/press/other/20080916a.htm.

[82] *Id.*

[83] Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., Address at the National Association for Business Economics 50th Annual Meeting, Washington D.C. (Oct. 7, 2008), *transcript available at* http://www.federalreserve.gov/newsevents/speech/bernanke20081007a.htm.

[84] Press Release, Bd. of Governors of the Fed. Reserve Sys. (Oct. 8, 2008), *available at* http://www.federalreserve.gov/newsevents/press/other/2008 1008a.htm.

application of the factors of Section 13(3), the only explanation was that this action would allow AIG to "replenish liquidity."[85]

5. Wachovia and the FDICIA

For seventeen years, the FDIC had not used the "systemic risk" exception of the FDICIA; that streak ended in until 2008. On September 26, Wachovia's stock plummeted 27% and depositors started to withdraw from their accounts any excess of $100,000 (what was insured by the FDIC at the time).[86] Afraid of the effects of Wachovia's possible failure, on September 29, the FDIC acted for the first time under the systemic risk exception of the 1991 FDICIA and ordered Wachovia to sell itself to Citigroup.[87] Before giving such order, as determined by FDICIA, the FDIC and the Fed made the recommendation to the Secretary of the Treasury.[88] The Secretary of the Treasury, in consultation with the President gave the approval.[89] As a result, all of Wachovia's depositors were protected.[90] As part of the deal, the FDIC agreed to take on all the losses to Wachovia's loan and investment portfolio in excess of $42 billion (that was assumed by Citigroup) from a pool of $312 billion in loans, in exchange for $12 billion in preferred stock and warrants from Citigroup.[91] Wachovia, however, ended up refusing the deal with Citigroup, and

[85] *Id.*
[86] Peter St. Onge, *Stunningly Swift fall for Wachovia*, CHARLOTTE OBSERVER, Sept. 30, 2008 *available at* http:/ /www.charlotteobserver.com/ 408/story/222685.html.
[87] Rick Rothacker & Kerry Hall, *Wachovia Faced a 'Silent' Bank Run*, CHARLOTTE OBSERVER, Oct. 2, 2008 *available at* http://www.charlotte observer.com/business/story/226799.html.
[88] Press Release, Fed. Deposit Ins. Corp. (Sept. 29, 2008) [hereinafter FDIC Sept. 29 Press Release], *available at* http://www.fdic.gov/news/news/ press/2008/pr08088.html.
[89] Press Release, U.S. Dep't of Treasury, Statement by
Henry Paulson, U.S. Sec'y of the Treasury, on the Sale of Wachovia Bank (Sept. 29, 2008), *available at* http://www.ustreas.gov/press/releases/ hp1164.htm ("I agree with the FDIC and the Federal Reserve that a failure of Wachovia would have posed a systemic risk.").
[90] FDIC Sept. 29 Press Release, *supra* note 88.
[91] Opinion, *Pre-Emptive Plumbing*, WALL ST. J., Sept. 30, 2008, at A18.

sold itself to Wells Fargo in an unassisted transaction.[92]

6. Fannie Mae, Freddie Mac and HERA

On Sunday September 7, 2008, the FHFA appointed itself the conservator of Freddie Mac and Fannie Mae.[93] At the end of trading on the previous Friday, Fannie and Freddie's shares fell more than 80%.[94] In his statement, the Director of the FHFA, James B. Lockhart, expressed that the actions were in response to safety and soundness concerns.[95] Besides safety and soundness concerns, Lockhart's determination was based on the condition of the current market, Freddie and Fannie's financial performance and condition, their "inability to fund themselves according to normal practices and prices," and the important role that Freddie and Fannie play in the residential mortgage market.[96] Freddie Mac and Fannie Mae actually consented to Lockhart's decision of placing the FHFA as their conservator; consent is an acceptable ground to make the appointment.[97] As part of the conservatorship, the FHFA assumed the power of the Board and management and replaced the CEOs of both GSEs.[98]

7. Injection of Capital and EESA

On October 14, the Secretary of the Treasury outlined how it would use the first $250 billion in the implementation of EESA.[99]

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[92] Press Release, Bd. of Governors of the Fed. Reserve Sys. (Oct. 12, 2008), *available at* http://www.federalreserve.gov/newsevents/press/orders/20081012a.htm.
[93] Press Release, Office of Fed. Hous. Enterprise Oversight, Statement of, James B. Lockhart, dir., Fed. Hous. Fin. Agency, (Sept. 7, 2008) [hereinafter FHFA Press Release], *available at* http://www.ofheo.gov/media/statements/FHFAStatement9708.pdf.
[94] David Ellis, *U.S. Seizes Fannie and Freddie*, CNNMONEY.COM, Sept. 7, 2008, *available at* http://money.cnn.com/2008/09/07/news/companies/fannie_freddie/index.htm?postversion=2008090711.
[95] FHFA Press Release, *supra* note 93.
[96] *Id.*
[97] *Id.*; *see also* Zachary A. Goldfarb et al., *Treasury to Rescue Fannie and Freddie*, WASH. POST, Sept. 7, 2008 at A01.
[98] FHFA Press Release, *supra* note 93.
[99] Deborah Solomon & David Enrich, *Devil Is in Bailout's Details*, WALL ST. J., Oct. 15, 2008, at A1.

The Treasury introduced the voluntary Capital Purchase Program, in which bank and financial holding companies, along with other insured depository institutions and savings and loan holding companies engaged only in financial activities authorized by the law, can apply to participate and sell shares of preferred stock to the government.[100] The stated purpose of the program at its inception was to improve the lending capacity of these institutions and promote economic growth.[101] The Treasury would acquire non-voting senior preferred shares that pay a cumulative dividend rate of 5% a year for the first five years and a rate of 9% a year thereafter.[102] The shares are callable at par after three years, or redeemable before then "with the proceeds from a qualifying equity offering of any Tier 1 perpetual preferred or common stock."[103] The Treasury also gets warrants to purchase common stock limited to 15% of its total investment in the institution.[104] Moreover, to comply with the unjust enrichment provision, the Treasury requires the participating organizations to adopt certain standards that relate to prohibiting excessive compensation of senior executives.[105]

At the time the Secretary of the Treasury introduced the program, he also announced that nine major financial institutions had already agreed to participate in the program.[106] There is no mention of these institutions applying to TARP. The Treasury essentially forced nine US banks to participate in the program and offered a total of $125 billion to these nine institutions.[107] The remaining $125

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[100] U.S. Dep't of the Treasury, Application Guidelines for TARP Capital Purchase Program (Nov. 17, 2008) [hereinafter TARP CPP Guidelines], *available at* http://treas.gov/press/releases/reports/applicationguidelines.pdf.
[101] Press Release, U.S. Dep't of the Treasury, Joint Statement by Treasury, Federal Reserve and FDIC (Oct. 14, 2008) *available at* http://treas. gov/press/releases/hp1206.htm.
[102] TARP CPP Guidelines, *supra* note 100.
[103] *Id.*
[104] *Id.* ("Treasury will receive warrants to purchase common stock with an aggregate market price equal to 15 percent of the senior preferred investment.").
[105] *Id.*
[106] *Id.*
[107] Solomon & Enrich, s*upra* note 99 (stating that the government agreed to buy $25 billion each from Bank of America, J.P. Morgan, Citigroup and Wells Fargo, $10 billion from Goldman Sachs and Morgan Stanley, $ 3 billion from Bank of New York Mellon, and around $2 billion from State Street Bank).

billion has been made available to medium and small institutions that apply, but subject to approval.[108]

8. Citigroup, EESA and FDICIA

Citigroup, the second largest U.S. bank by assets[109], was one of the large financial institutions that seemed to be standing still in the midst of the financial crisis. On Friday November 21, 2008, the giant succumbed when the price of their stock went down to $3.77, 60% lower than at the beginning of the week and totaling a 72% loss during the month of November.[110] Critics speculate that the cause of such plunge in the stock price was the Treasury's announcement earlier in the month that they would no longer buy toxic assets from banks.[111] As the situation quickly worsened, Citigroup's top officers and government officials started to look for options to stabilize the company and boost investor's confidence.[112] Late on November 23, the FDIC, Fed and Treasury revealed the bailout plan.[113] The plan included a series of transactions between Citigroup, FDIC, Fed and Treasury.[114] Treasury, FDIC and the Fed will protect against losses in a $306 billion pool of loans and securities backed by real estate and other similar assets.[115] Citigroup will keep these assets in their balance sheet.[116] Citigroup is responsible for the first $29 billion in

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[108] *Id.*

[109] Dan Wilchins and Jonathan Stempel, *Citigroup Shares Drop,* REUTERS, Nov. 21, 2008, *available at* http://www.reuters.com/article/ousiv/idUSTRE4AJ45G20081121.

[110] Rob Curran, *Large Stock Focus: Citigroup's November Swoon,* WALL ST. J., Nov. 22, 2008, at B3.

[111] *Id*; *see also* Press Release, U.S. Dep't of the Treasury, Remarks by Sec'y Henry M. Paulson, Jr. on Financial Rescue Package and Economic Update (Nov. 12, 2008), *available at* http://ustreas.gov/press/releases/hp1265.htm (declaring that Treasury was not planning to buy any additional distressed mortgage assets).

[112] David Enrich et al., *U.S. Agrees to Rescue Struggling Citigroup*, WALL ST. J., Nov. 24, 2008, at A1.

[113] Press Release, U.S. Dep't of the Treasury, Joint Statement by Treasury, Federal Reserve and the FDIC on Citigroup (Nov. 23, 2008), *available at* http://ustreas.gov/press/releases/hp1287.htm.

[114] *Id.*

[115] *Id.*

[116] U.S. Dep't of Treasury, Summary of Terms (Nov. 23, 2008), *available at* http://ustreas.gov/press/releases/reports/cititermsheet _ 112308.pdf.

losses in the pool of assets and 10% of the remainder losses.[117] Treasury agreed to cover the next $5 billion in losses in the pool of assets, and the FDIC will cover the next $10 billion in losses.[118] The Fed agreed to cover all losses beyond that point through a non-recourse loan.[119] In exchange for the protection, Citigroup will issue non-voting preferred stock to the FDIC and the Treasury.[120] Citigroup agreed to submit an executive compensation plan with restrictions to be approved by the government.[121] Also, the Treasury will invest $20 billion in Citigroup from TARP in exchange for non-voting preferred stock with an 8% dividend.[122] The agencies stated that the actions were "necessary to strengthen the financial system and protect U.S. taxpayers and the U.S. economy."[123] The FDIC relied on the systemic risk exception under FDICIA and voted unanimously to get involved in the Citigroup rescue.[124] The Treasury relied on their authority under EESA to disburse the TARP funds.[125] The rapid reaction and the extent of the Citigroup bailout increased the criticism that the government "is willing to do anything to bail out the biggest banks, while letting smaller ones, consumers, and small companies, fail."[126]

D. Conclusion

TBTF statutes have granted wide discretion to the different agencies and without specific guidance. As applied, the laws have revealed a common purpose: to protect the general economy without much consideration to the investor or even the market. As the different government agencies have responded to failing institutions in 2008, the resulting actions by the Fed, Treasury, FDIC have

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[117] *Id.*
[118] *Id.*
[119] *Id.*
[120] *Id.* (allocating $4 billion to the Treasury and $3 billion to the FDIC, and an 8% dividend rate).
[121] *Id.*
[122] *Id.*
[123] *Id.*
[124] Damian Paletta, *FDIC Vote on Citi Was Unanimous*, WALL ST. J., Nov. 24, 2008, *available at* http://online.wsj.com/article/SB122753695817253015.htm.
[125] *See supra* notes 40-46 and accompanying text.
[126] Damian Paletta and Deborah Solomon, *Uncertainty on Strategy in Citi Rescue*, WALL ST. J., Nov. 25, 2008, at A10.

seemed random. With some institutions like Bear Stearns and AIG only the Fed responded. The FDIC responded to Wachovia, yet no one responded to Lehman Brothers. At the same time, the responses range from facilitating a deal, opening discount windows, placing the institution in conservatorship, etc. The lack of consistent government action in regards to TBTF institutions, while addressing some short-term problems, might end up perpetuating the financial crisis.

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