GRAHAMFISHER

December 17, 2008

Joshua Rosner
646/652-6207
jrosner@graham-fisher.com

An Urgent Agenda for Reactivating the Financial Sector

The current problems in the real economy are rooted in the excesses of the asset backed securities (ABS) market. These excesses can be traced to the misaligned incentives institutional investors had to invest in ABS. When interest rates were low institutional investors, whose charters require them to hold only investment grade assets (bank, pension and insurance asset managers), preferred to purchase higher yielding CDOs rather than treasury bonds, municipal bonds, corporate bonds or the underlying residential or commercial mortgage backed securities whose yields were relatively lower and were low on an absolute basis.

Wall Street firms met investor demand by directly or indirectly funding mortgages that, in prior periods, had been held on banks' balance sheets or guaranteed by Fannie Mae, Freddie Mac, or the federal government. Wall Street firms bundled these mortgages into the mortgage-backed securities that CDOs purchased.

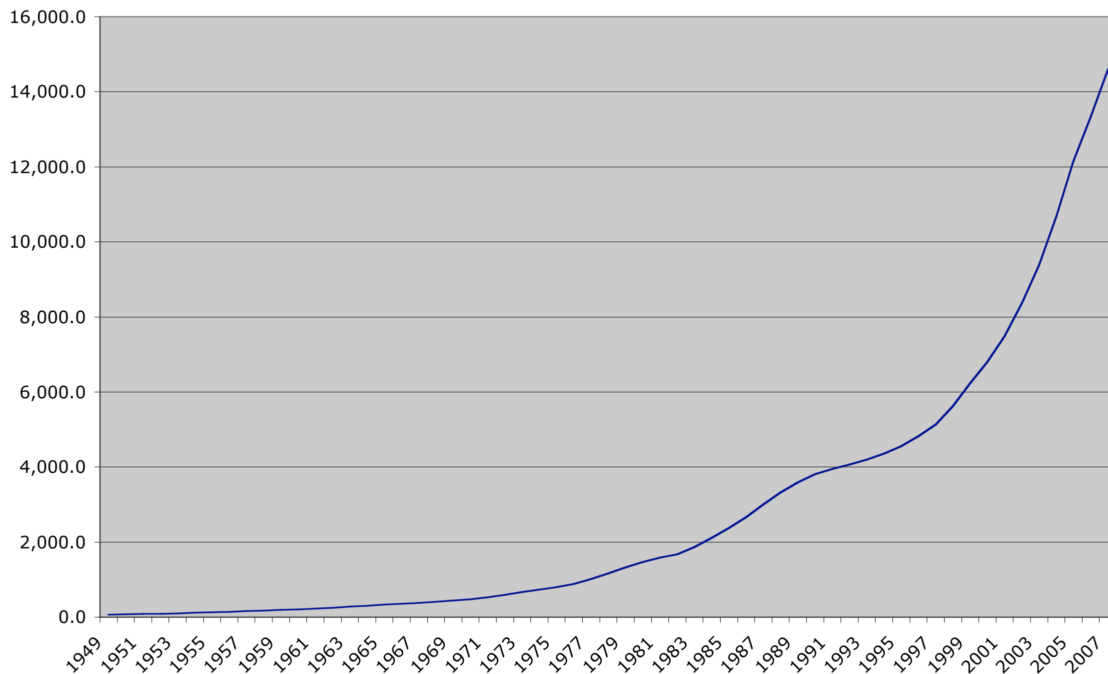
As demand for structured securities channeled increased levels of capital through the capital markets, the availability of capital spread outward to other areas of the real economy such as home equity loans, commercial loans, and construction loans. This effect can be demonstrated by the growth in number and size of new warehouse lines of credit banks provided to large and small mortgage issuers. Interest rates declined as more capital flowed into the real economy. Declining interest rates, in turn, stimulated further mortgage origination and refinancing.

The ABS market grew dramatically over this time, from $1 billion in new issues in 1985 to $997 billion in new issues in 2007. Despite this growth, it suffered from many problems. Specifically, the ABS market never developed a substantive regulatory framework and suffered from inadequate standards of information, inadequate market transparency, and unresolved legal questions.[1,2,3,4] These defects became apparent as

1. Lois R. Lupica, Revised Article 9, Securitization Transactions and the Bankruptcy Dynamic, 9 AM. BANKRUPTCY INST. L. REV. 287, 293 (*noting that* asset backed securities have grown from a relatively insignificant $1 billion market in 1985).
2. Asset Backed Alert, ABS Market Statistics, Dec. 4, 2008, *available at*: http://www.abalert.com/Public/MarketPlace/MarketStatistics/index.cfm
3. *See, e.g.,* Jessica L. Debruin, *Recent Developments in and Legal Implications of Accounting for Securitizations,* 56 N.Y.U. ANN. SURV. AM. L. 367, 382 (1999), *available at*: http://www1.law.nyu.edu/pubs/annualsurvey/documents/56%20N.Y.U.%20Ann.%20Surv.%20Am.%20L.%20367%20(1999).pdf ("The Tenth Circuit in particular has been highly criticized, though not yet reversed, for its decision in a case involving true-sale analysis. Faced with a sale of accounts, the court in Octagon Gas Systems, Inc. v. Rimmer applied the provisions of Article 9 of the UCC to determine that the transaction constituted a security interest rather than a true sale.").

investor concerns grew about collateral backing securities and about the robustness of these markets.

As a result, "markets" ceased to function, investor confidence fell, the prices of the securities collapsed, and confidence in financial intermediaries diminished. Formerly acceptable levels of opacity and information asymmetry turned to suspicion and distrust among counterparties.[5] Without regulatory intervention to force disclosure standards in support of information symmetry, capital fled and funding disappeared for real economic activity.



Source: Federal Reserve, Fed Flow of Funds Data

4. *See* Joseph R. Mason & Joshua Rosner, Where Did the Risk Go? How Misapplied Bond Ratings Cause Mortgage Backed Securities and Collateralized Debt Obligation Market Disruptions, Working Paper, May 2007, *available at:* www.hudson.org/files/publications/Hudson_Mortgage_Paper5_3_07.pdf, at 34 p.34"(See: "In December 2000, LTV Steel filed for voluntary Bankruptcy protection under Chapter 11 in the US Bankruptcy Court of Northern Ohio 121. In their filing the Company asked the court to grant an emergency motion to allow them to use the collections from the securitizations and claimed that the transactions were not "true sales" but rather "disguised financings". The Court granted the Company's motion though it did not rule whether or not the securitizations were "true sales". … In fact, one of the agencies appeared to pressure attorneys to avoid commenting on the matter in legal opinions. "Standard & Poor's insisted that attorneys submitting true-sale opinions to the rating agency stop referring to LTV, noting that the court never made a final decision and that such citations inappropriately cast doubt on the opinion. Seven months later, in a delicately worded press release, S&P withdrew that prohibition--apparently because lawyers refused to ignore such an obvious legal land mine.")" [hereinafter *Mason & Rosner May 2007].*

5. That is, the level of opacity and information asymmetry was acceptable during the preceding time of excess liquidity.

When, in an effort to slow excesses in the housing market, the Federal Reserve increased interest rates between February 2005 and 2006it caused a contraction of capital to the credit origination industry and a resulting contraction in the securitization market and, in turn, the real economy.[6] Investors began to see rising early mortgage payment defaults as a sign of future trouble and began to think soberly about how unjustifiably weak underwriting standards had become. Demand for new CDOs ground to a halt and demand for new mortgage backed securities dried up. The future seeds of the real crisis—the destruction of the already weak infrastructure of securitization—began to take hold.

These problems were and are not constrained to housing; they extend(ed) to other areas of consumer financing (home equity, cards, auto) and commercial financing (commercial mortgages, construction loans, bank trust preferred, corporate loans, commercial paper…). To define housing as the root of the problem is to define the house as precursor to the hammer. Given that our current recession is consumer led, other assets funded by securitization will follow the housing market in a downward spiral.[7] Even if it was possible for the Treasury to bear the full economic obligation of the housing market, it could not also bear the weight of a decline in other consumer assets or the commercial economy.

If it is correct that the real economy problems with housing are not the **root** of the problem, then problems in the real economy (such as commercial mortgages, construction loans or auto loans) are symptoms of frozen securitization markets. It would be both inefficient and ineffective to focus on the real asset without first repairing the many glaring structural weaknesses.
Although skeptics may argue that the securitization is broken beyond repair, it had served as a critical tool of intermediation and must either be revived or replaced with a more viable tool with less opacity, less complexity, and with an improved capacity for rational

---

6. *See* Federal Reserve Board, Open Market Operations, *available at:* http://www.federalreserve.gov/fomc/fundsrate.htm

7. *See Joseph R. Mason & Joshua Rosner, How Resilient Are Mortgage Backed Securities to Collateralized Debt Obligation Market Disruptions?, Working Paper, Feb. 15, 2007 [hereinafter Mason & Rosner February 2007]*, at 33 ("As yet, there are not enough RMBS downgrades to manifest a similar effect, but the lags between ABS and CDO downgrades suggest a similar lag in defaults will result with respect to current RMBS pool difficulties. CDOs invested heavily in manufactured housing, aircraft lease, franchise business loan, and 12-b1 mutual fund fee ABS prior to 2003. CDOs with heavy exposure to those collateral classes took a beating when collateral underperformance and fraud revealed heavy losses in the pools and, subsequently, a great many defaults on ABS in those sectors. As Lucas, Goodman and Fabozzi (2006) note, CDOs moved out of those sectors following the defaults. More importantly for our purposes, however, is the fact that the collateral sectors that caused difficulties for CDOs in 2003 shrunk considerably afterward. The manufactured housing, aircraft lease, franchise business loan, and 12-b1 mutual fund fee ABS sectors are significantly smaller than they were when CDOs were pouring in during 1999-2001. We argue that the shrinkage in those sectors arose from decreased funding by the CDO markets. We therefore maintain that the shrinkage in RMBS sector is likely to arise from decreased funding by the CDO markets as defaults accumulate. Of course, mortgage markets are socially and economically more important than manufactured housing, aircraft leases, franchise business loans, and 12-b1 mutual fund fees. Decreased funding for RMBS could set off a downward spiral in credit availability that can deprive individuals of home ownership and substantially hurt the U.S. economy. As described in detail in section II.A, the CDO market adds liquidity to the RMBS market in a highly leveraged fashion by funding lower-tranche MBS securities, and the experience of the ABS markets in the early 2000s illustrates that the liquidity provided by CDOs is very fragile.").

market-based product pricing. A failure to foster intermediation external to the depository system will risk an ongoing shrinkage of market funding for economic activity, precipitating greater deflation.

Functioning securitization markets could stabilize the present situation. I f securitization markets functioned (with mortgage rates at about 5.5%),[8] troubled ARMS borrowers could to refinance into cheaper fixed-rate mortgages without government assistance.

Securitization Rates for Home Mortgages
(Dollars in Billions)

Total	Total	Conforming	Prime Jumbo	Aub/Alt A	FHA/VA	Seconds
2001 Securitization Rate	60.70%	72.30%	32.00%	45.80%	98.70%	13.50%
MBS Issuance	$1,344.70	$914.90	$142.20	$98.40	$172.70	$15.50
Estimated Originations	$2,215.00	$1,265.00	$445.00	$215.00	$175.00	$115.00
2002 Securitization Rate	63.00%	74.50%	30.00%	66.00%	97.80%	15.00%
MBS Issuance	$1,817.40	$1,270.40	$171.50	$176.10	$172.20	$24.80
Estimated Originations	$2,885.00	$1,706.00	$571.00	$267.00	$176.00	$165.00
2003 Securitization Rate	67.50%	77.70%	36.50%	68.10%	99.30%	9.30%
MBS Issuance	$2,662.40	$1,912.40	$237.50	$269.10	$218.50	$20.40
Estimated Originations	$3,945.00	$2,460.00	$650.00	$395.00	$220.00	$220.00
2004 Securitization Rate	62.60%	73.70%	45.30%	72.90%	95.80%	13.80%
MBS Issuance	$1,826.80	$892.30	$233.40	$521.10	$126.40	$49.10
Estimated Originations	$2,920.00	$1,210.00	$515.00	$715.00	$132.00	$355.00
2005 Securitization Rate	67.70%	80.50%	49.20%	79.30%	99.50%	16.60%
MBS Issuance	$2,111.80	$879.10	$280.70	$797.40	$85.60	$60.70
Estimated Originations	$3,120.00	$1,092.00	$570.00	$1,005.00	$86.00	$365.00
2006 Securitization Rate	67.60%	82.50%	45.60%	81.40%	100.20%	17.30%
MBS Issuance	$2,016.00	$816.90	$219.00	$814.30	$83.20	$74.20
Estimated Originations	$2,980.00	$990.00	$480.00	$1,000.00	$83.00	$430.00
2007 Securitization Rate	74.20%	91.40%	51.30%	92.80%	97.70%	9.30%
MBS Issuance	$1,804.20	$1,062.00	$178.10	$432.50	$98.60	$32.90
Estimated Originations	$2,430.00	$1,162.00	$347.00	$466.00	$101.00	$355.00
4Q07 Securitization Rate	75.40%	96.40%	43.80%	55.40%	102.90%	1.50%
MBS Issuance	$339.10	$264.60	$19.30	$22.50	$31.90	$0.90
Estimated Originations	$450.00	$274.50	$44.00	$40.50	$31.00	$60.00

Source: Inside MBS & ABS
Notes: Total MBS excludes re-securitizations, scratch-and-dent MBS and deals backed by seasoned loans. Conforming includes Conventional conforming mortgages and Fannie/Freddie MBS. Seconds include home-equity lines of credit and closed-end seconds; some second mortgages are also securitized in subprime and other MBS products.

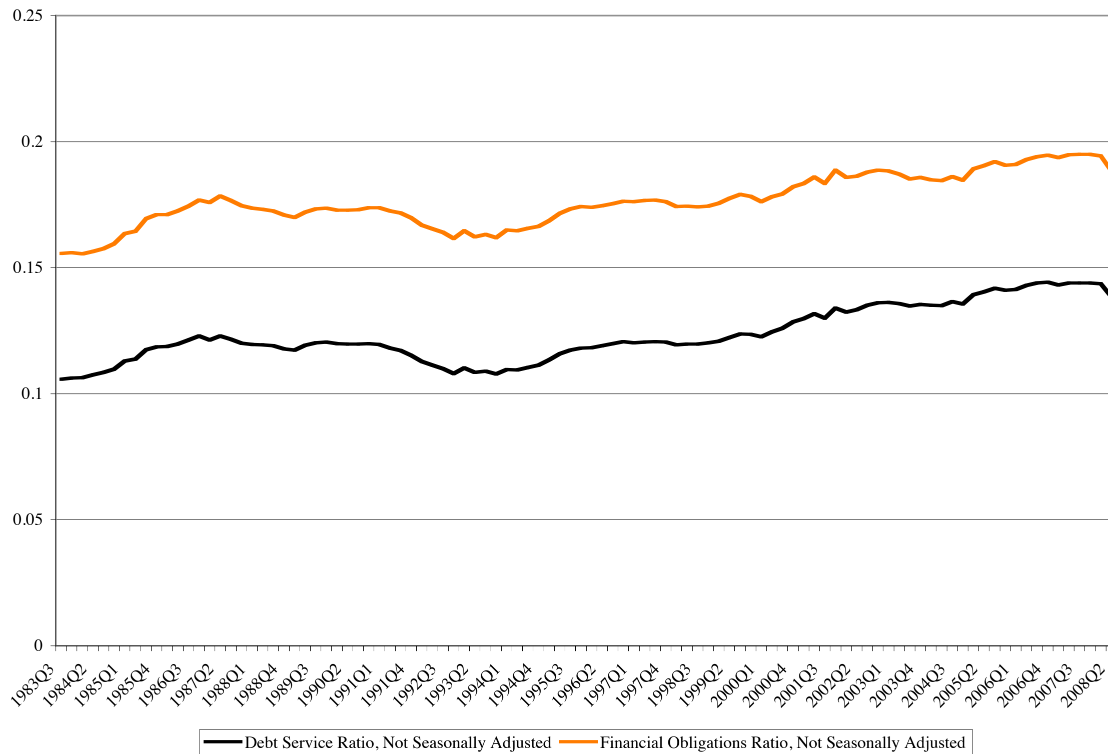
Markets are pricing in a continued decline in the real economy. In response, regulators, policymakers, and legislators must coordinate a response of unprecedented proportions.

To believe that focusing on housing as either the root or the basis for stabilizing the housing market is a frightening oversimplification. Housing will not stabilize until we have corrected for either overleveraged consumers and rising unemployment or those other weak asset classes that will accelerate housing's downturn. Larger and unaddressed problems remain ahead of us.

8. Current Mortgage Rates & Mortgage Interest Rates Survey, *available at:* http://www.mortgage101.com/Articles/DailyRateSurvey.asp.

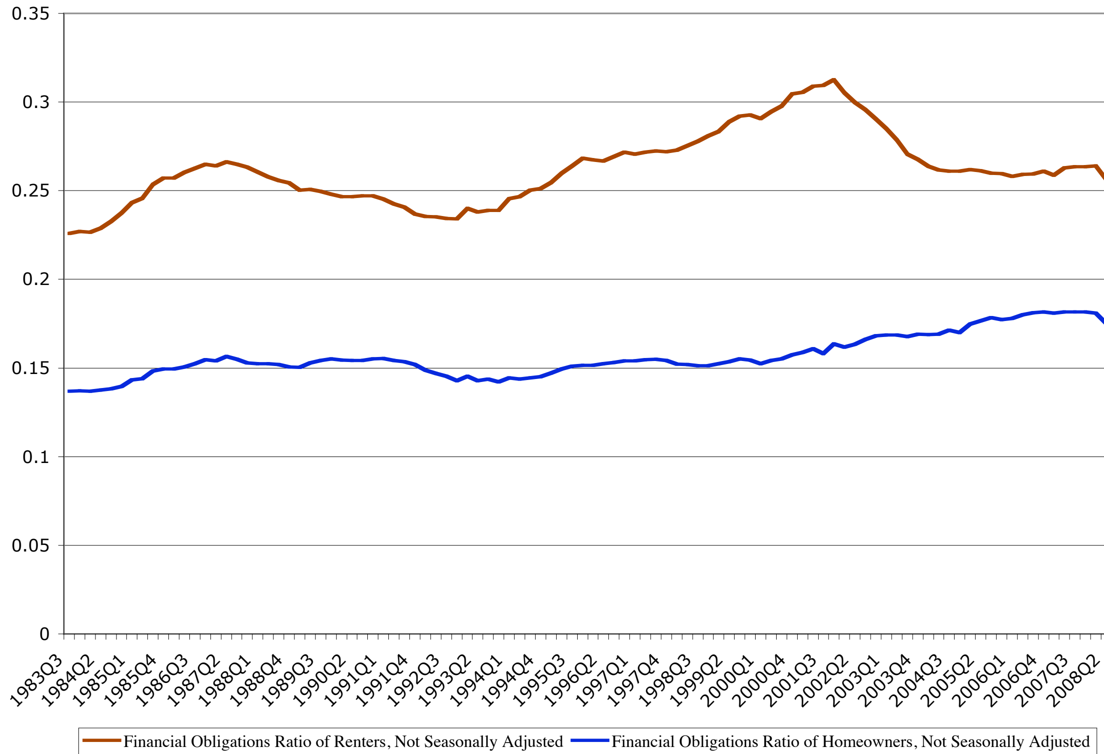
Consumers are indebted to a degree that is unappreciated and rarely discussed. Unlike the federal government, consumers do not have the ability to print money to pay off their debts. In other words, these debts must be paid back. Many policymakers would argue that the increase in absolute consumer debt is not the correct barometer to gauge the health of the consumer. Instead, they would argue monthly debt and interest payments (mortgage payments, minimum credit card payments, auto payments) as a percentage of disposable income as a better barometer of consumer capacity to consume. Federal Reserve Board figures indicate that, prior to this decade, the percentage of disposable income required to satisfy a consumer's minimum monthly debt burden (the "Debt Service Ratio") had been relatively constant. Even with the growth during this decade it has still never exceeded 15% of disposable income."[9]

Debt Service Ratio: 1983-2008



9. Joshua Rosner, Housing in the New Millennium: A Home Without Equity Is Just a Rental with Debt, GrahamFisher Analyst Report, June 29, 2001 [hereinafter *Housing in the New Millennium*], at 17.

Financial Obligation Ratio, 1983-2008

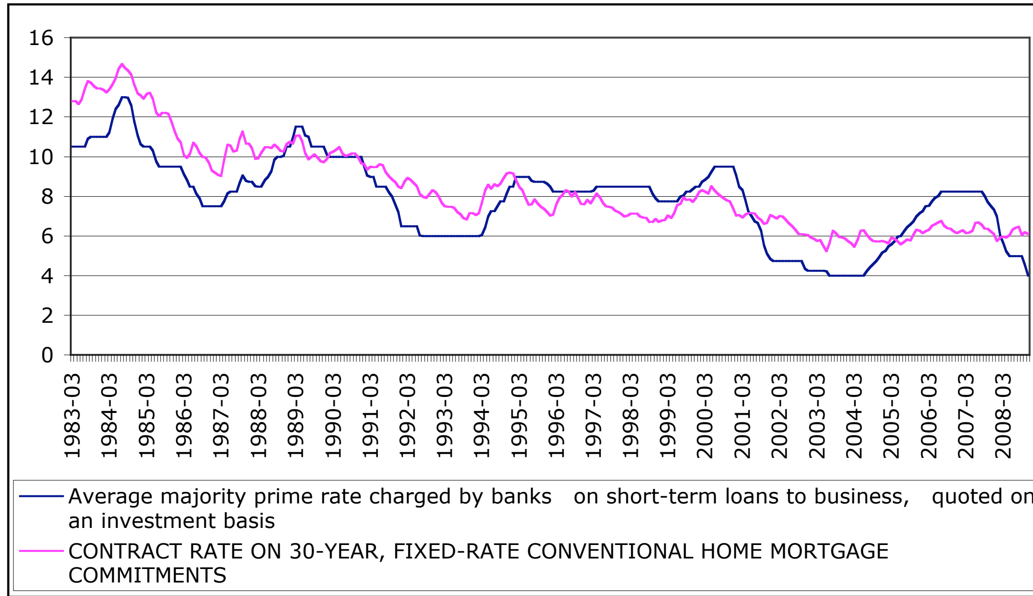


Consumer balance sheets are far worse than they appear. The Fed's DSR and FOR data that are of limited use. Consider the Debt Service Ratio (DSR). The DSR is an estimate of the ratio of minimum monthly debt payments to disposable personal income. In this case, however, the debt payments consist of the estimated required payments on outstanding mortgage and consumer debt—in other words- *payments due* - the "minimum due" number in the little box on your monthly statement. This measurement is far too narrow. The chart above broadens the DSR data to include the Financial Obligations Ratio (FOR). The FOR adds automobile lease payments, rental payments on tenant-occupied (owned) property, homeowners' insurance and property tax payments to the debt service ratio DSR.

These data fail to consider whether obligations are fixed or floating rate obligations and do not offer information on the duration of fixed percentages of obligations. As a result, the data necessarily draws viewers' eyes away from consideration of the dramatic absolute growth of consumer debt in the face of massive and prolonged declines in interest rates. If one believes that borrowers, in aggregate are rational, then there must be a natural ratio at which borrowers are unwilling to continue to grow their debts relative to income. With negative real savings we may have reached the point at which monetary stimulus is an ineffective tool to stimulate demand.

These events were fueled by the Federal Reserve's easy credit policies. The problems hit us on the head like the apple waking Rip Van Winkle and, were we to see dramatic

deflation, borrowers would be crushed by the burdens of their debts. Unfortunately, non-market based solutions that focus on reduction in interest rates as opposed to reduction in principal balances create a toxic problem where the necessary and desired reflation, and increase in interest rates, would have adverse consequences.



On the surface circumstance appears to argue in favor of the importance of addressing the real economy's *housing* problems. It seems more reasonable to distinguish and suggest the market's *mortgage* problem must be addressed in the context of other areas of debt that are economically at risk. The problems resulting from the shutting down of different areas of the securitization markets represent an ongoing waterfall of losses. Even if it is possible to, in isolation, stabilize one asset class, given the disruption of the credit allocation resulting from "unplanned changes in the channels of credit flow" and the "actual failures (of lenders) caused a contraction of the [banking] systems role in the intermediation of credit", it will be an ineffective use of government funds as the deleveraging spreads.[10]

In a consumer led slowdown, obviously, business activity also weakens. Without top-line and export or replacement cycle driven business activity expansion to drive the economy - as consumer debts reach a natural limit - there are stresses on auto, mortgage and credit card payments leading to defaults and asset price declines. As prices decline this effect causes savers to hoard out of fear of committing capital. As the retrenchment progresses and consumers abandon all non-discretionary spending, retail suffers and demand for new inventory slows. These effects cause slowdowns in manufacturing and warehousing of inventory. As businesses try to re-size for survival, they begin to aggressively manage general and administrative spending. This cost management leads to cut backs in staffing and spending and leads to the next leg of the downward cycle. Unfortunately, this

10. Ben S. Bernanke, *Nonmonetary Effects of the Financial Crisis in Propagation of the Great Depression,* 73 AM. ECON. REV. 257-76 (1983), at 264.

traditional problem of consumer led slowdowns is neither novel nor easy to manage. That is especially so in this cycle.

The U.S. consumer, the global engine of growth, has become exhausted. Other nations' consumers have never embraced debt financing as ours have, and it appears unlikely that they now will. Moreover, foreign capital has rushed to our shores betting on the ability of our consumers to spend their money. Just when it would be nice to see them spend their money, we cannot let them take it back. Unfortunately, they cannot spend the same dollar twice and, with aging populations, they will eventually need to take their money home. Our problems are compounded by the ease with which money crosses borders today; the global bubble would have been almost impossible to manufacture through the traditional banking system in which banks funded the expansion in credit and the Fed and other regulators controlled the flow of capital to the banks.

Step 1: Expand the Money Supply

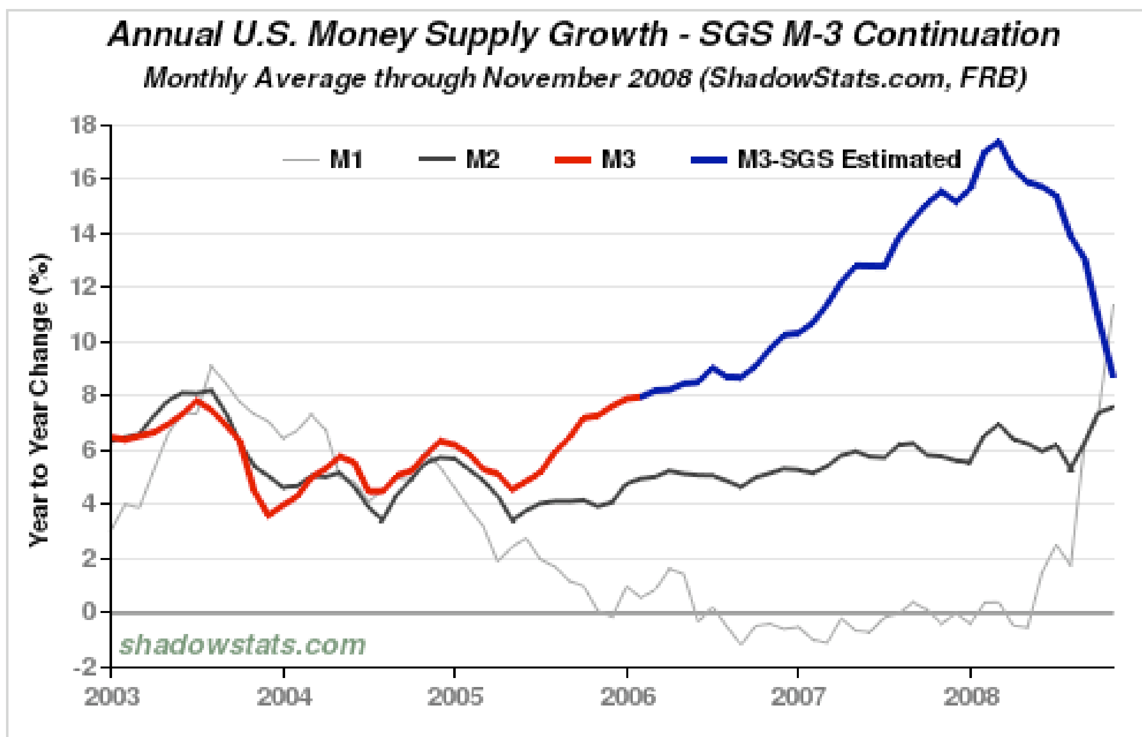
In a controversial midyear 2007 report,[11] regulators and policymakers were warned of the risks that the United States was facing a Japanese-like decade. It was suggested the root of the problem was not liquidity but a lack of standards, a lack of disclosures to investors, and a lack of a market in which to price and value structured securities and to fund real assets. **Since that report, losses have been allowed to grow so aggressively that we have stripped the gears of the financial system and now need to flood the system with liquidity to buy time as we set about repairing the funding mechanism.**

The Fed must act even more dramatically to expand the monetary base as it sets about to resolve failed financial institutions and the transfer of troubled assets from the balance sheets of insolvent institutions to willing buyers. Just as a surgeon sustains a patient with an IV drip while he is re-opening a wound, the government must now provide ample unsterilized liquidity to the market while it reconstructs the banking sector, realigns public policy with market based incentives and lays the groundwork for a more robust securitization market.

Thus far government attempts to liquefy markets have failed because additional liquidity has not, and cannot stimulate demand on its own. Although the public does not have a great deal of information to assess the monetary expansion and therefore cannot

11. For more information, *see Hidden Subprime Losses May Mirror Japan Bank Crisis*, REUTERS, July 31, 2007, *available at:* http://www.reuters.com/article/companyNewsAndPR/idUSN3137008020070731 ("Investors and banks holding on to U.S. subprime mortgage bonds in hopes of a recovery in value may make losses worse, mirroring the Japanese banking crisis in the 1990s, according to a new report…The Japanese banking crisis, triggered in the early 1990s by a slumping property market and brokerage collapses, led to a decade-long credit crunch. The government subsequently had to step in to stabilize the banking system by injecting public money into top banks…"The Japanese experience of holding large losses as opposed to taking a hit and moving on was a direct cause of the Japanese malaise," said Josh Rosner, author of the report and a managing director at Graham Fisher, an investment research firm in New York…The new report, "Financial Services Exposures to Subprime," said "there are many institutions with significant levels of embedded losses that have not yet been recognized as a result of questionable valuations." More investors are hiding losses that may only get worse, the report said. Growing concern about the deteriorating U.S. housing market may hurt corporate buyouts, debt financing and stock markets.").

confidently assess the effectiveness of the Fed's attempts to inflate[12], from a re-creation of the M3 data (below) it appears we cannot wait two months for a new administration.



Courtesy of ShadowStats.com

If the TIPS are considered a near proxy for properly gauging inflation, the Fed should consider a policy that includes specifically targeting the TIPS market and should expand the monetary base at least until the TIPS market builds a positive rate of inflation into expectations.[13] As Chairman Bernanke has specifically recognized, "Deflation has particularly insidious effects on debtors"[14] Given the indebtedness of our consumers, our corporations, and our country, an aggressive anti-deflationary policy is an imperative.

---

12. Specifically, the government has reduced information regarding the money supply. *See* Tim McMahon, *Goodbye M3 -- What is the Government Hiding?*, Mar. 16, 2006, *available at:* http://www.inflationdata.com/inflation/inflation_articles/m3_money_supply.asp ("As of March 23rd 2006 the government will no longer be publishing the M3 money supply data… The most restrictive, M1, only measures the most liquid forms of money; it is limited to currency actually in the hands of the public. This includes travelers' checks, demand deposits (checking accounts), and other deposits against which checks can be written. M2 includes all of M1, plus savings accounts, time deposits of under $100,000, and balances in retail money market mutual funds. But that is all small potatoes, M3 includes all of M2 (which includes M1) plus large-denomination ($100,000 or more) time deposits, balances in institutional money funds, repurchase liabilities issued by depository institutions, and Eurodollars held by U.S. residents at foreign branches of U.S. banks and at all banks in the United Kingdom and Canada.").
13. U.S. Treasury Department, TIPS/CPI Data, *available at*: http://www.treasurydirect.gov/instit/annceresult/tipscpi/tipscpi.htm
14. Ben Bernanke, "Bernanke's Thoughts on the Great Depression, c. 2005", available at: http://blogs.wsj.com/economics/2007/09/17/bernankes-thoughts-on-the-great-depression-c-2005/

The failures of both the U.S. government's response in the early 1930's and the more recent failures of Japanese monetary and fiscal policy were direct results of "too little, too late" policy responses.[15] Contrary to the view that our current crisis began in July of 2007, history suggests it accurately should be considered to have begun with the tightening of rates in 2005 and 2006 and the resulting collapse of the non-bank mortgage lending industry. It has been two years since the beginning of the debt deflation in this country and the scale of our response has been feeble and uncoordinated. As Bernanke and Gertler have demonstrated, **"asset price crashes have done sustained damage to the economy only in cases when monetary policy remained unresponsive or actively reinforced deflationary pressures."**[16] If we are to avoid an ongoing series of severe deflations our monetary policy actions must be immediate, targeted and massive[17]. Given that headline inflation figures have turned negative it is likely that with each successive inflation data point it will become more difficult to reverse increasingly persistent expectations of deflation. Thus, each dollar committed today would have a greater simulative value than equal dollars committed over a longer period.

Perhaps, at some future point, we will have to rapidly withdraw liquidity to avoid excessive inflation. Nevertheless the present deflationary risks threaten to break corporate and consumer debtors while stimulating nominal levels of inflation in an economy in which consumer debt-to-income is at historic records is the only way to decrease that burden. We must, however, seek to inflate in a manner that allocates the expansion in money toward increases in real wages/income as opposed to merely, again, increasing the allowable level of indebtedness.[18]

---

15. *See* Ito, Takatoshi and Mishkin, Frederic S., Two Decades of Japanese Monetary Policy and the Deflation Problem, NBER Working Paper No. W10878, Nov. 2004, *available at*: http://www0.gsb.columbia.edu/faculty/fmishkin/PDFpapers/2536-w10878.pdf, at 21 ("Indeed, learning lessons from the Japanese situations was a popular exercise in the United States with an intention to avoid deflation. Clouse, et al (2000) went through a menu of options that the central bank can think of adopting at the zero interest rate, and Ahearne et al. (2002) critically evaluated the Bank of Japan policy. The latter came down to a conclusion that the Japanese monetary policy was too tight from 1992 to 1995. Bernanke and Gertler (1999), Jinushi et al. (2000), McCallum (2003), and Taylor (2001) obtained a similar conclusion that monetary loosening after 1992 was too slow (with varying changes of degree and period).").

16. Bernanke, Ben S. and Gertler, Mark, Monetary Policy and Asset Price Volatility, NBER Working Paper No. W7559, Feb. 2000, *available at*: http://www.frbkc.org/PUBLICAT/SYMPOS/1999/4q99bern.pdf, at. 18.

17. Goodfriend, Marvin, "Financial Stability, Deflation, and Monetary Policy," 19 MONETARY AND ECONOMIC STUDIES 143-167, Feb. 2001 ("Monetary policy has the power to preempt deflationary forces, and the power to overcome the zero bound on interest rates to restore price stability and prosperity after a deflationary shock. Fiscal policy, on the other hand, is likely to be relatively ineffective at best and counterproductive at worst.").

18. *See, e.g.,* Garet Garrett, "A BUBBLE THAT BROKE THE WORLD", (Boston: Little, Brown & Company, 1 ed., 1932), at 28-29 ("Since John Law and his Mississippi Bubble, individuals have been continually appearing with the same scheme in new disguise. The principle is very simple. You have only to find a new way to multiply your creditors by the cube and pay them by the square, out of their own money. Then for a while you are Nabob. One fish cut up for bait brings three. Two of these cut up for bait bring eight, the cube of two. Four of these cut up for bait bring sixty-four, the cube of four. Sixteen of these for bait bring 4,096, and 256 of these, which is the square of sixteen, will bring 16,777,216, which is the cube of 256. The fatal weakness of this scheme is that you cannot stop. When new creditors fail to present themselves faster than old creditors demand to be paid off, the bubble bursts… There is nothing new in the scheme. What is new is that for the first time the whole world tried it. The whole world cannot put itself in jail nor can it escape the consequences by suicide. When the delusion breaks, people all with one impulse hoard their money, banks all with one impulse hoard credit, and debt becomes debt again, as it always was. Credit is ruined. Suddenly there is not enough for everyday purposes.").

Step 2: Return to Private Market Incentives, Let Markets Clear:

The original intent of Treasury Secretary Paulson's Troubled Asset Relief Program (TARP) was, by removing troubled assets from the balance sheets of financial institutions, to achieve a stabilizing effect. Although the idea was noble, the problem with the Paulson plan was the manner in which they intended to execute it. For Treasury to come up with a price that represented the underlying "value" of the securities there would need to be a standard of value or standardized valuation tools that do not exist in the marketplace – and whose lack is at the root of the crisis. Instead, Treasury planned on using taxpayer funds to purchase securities whose values were difficult to determine; bidders argued the value for them was well below what the financial institution holding them stated they were worth. If Treasury bought them at the prices that the holders were valuing them at there was a risk they would be overpaying for them, creating false price signals to the markets and rewarding those holders that falsely overvalued their assets. Conversely, if Treasury had to determine a price on its own it would have to rely on yet another model that could be wrong and would, by pricing below what the holder was carrying the asset at, result in a loss to the holder as they wrote down the value to the Treasury's price.

Recognizing both these problems and the risk of a new unintended asset bubble had they operationalized this program, Treasury chose to inject capital into banks in an effort to prevent them from failing and to create incentives for them to lend. Having done so without first removing illiquid, poorly performing and difficult to value assets from bank balance sheets has ensured that, as bad assets continue to deteriorate and require offsetting increases in regulatory capital, capital infusions have served more as a pain reliever than an antibiotic. Also, by not requiring that banks raise equity capital from private investors as a precondition to receiving "TARP" money, the Treasury's capital injection program may have actually reduced market liquidity as market disciplines have become distorted. Capital markets are designed to properly allocate capital toward healthy and efficient users of capital and away from those users of capital that are uneconomic and inefficient. Market participants, from the outset, recognized several of the original recipients of Treasury monies would likely be insolvent if the assumptions used in marking their loan books and investments were reasonable or the economy weakens further causing other asset values to decline. By propping up these likely insolvent institutions and funding their uneconomic businesses, the government aid program has created a marketplace where uneconomic capital, in the hands of uneconomic institutions, will likely cause those currently healthy institutions to choose to either withdraw from markets or attempt to compete with uneconomic capital and risk their own safety. This, coupled with ongoing use of Treasury capital to attempt to find solvency through risky asset purchases present major dangers of moral hazard.

End of Moral Hazard

Between the failure of Long Term Capital Management and the early stages of this crisis, we regularly heard Federal Reserve Board officials reiterate the view that nobody was too

big to fail.[19] It was argued in speeches, policy papers, and academic journals that LTCM taught us that even the largest and most complex enterprise, with adequate capital and time, could be wound down and safely resolved.

In a stunning reversal (and with Orwellian verve), Treasury Secretary Paulson announced that investors should just accept that some financial institutions are too big to fail.[20] In Orwellian terms it might be stated 'all financial institutions are equal, but some are more equal than others.' Ironically, this policy comes as many of our largest financial institutions have gone through unfettered growth and are now teetering on failure as a

19. *See, e.g.,* Chairman Ben S. Bernanke, "Regulation and Financial Innovation", Federal Reserve Bank of Atlanta's 2007 Financial Markets Conference, Sea Island, Georgia (via satellite), May 15, 2007 (*"Some care is needed in applying a risk-focused approach to regulation, however. In particular, when the government singles out particular institutions or markets as being especially critical to the stability of the system, moral hazard concerns may well follow.* ***A perception that some institutions are "too big to fail" may create incentives for excessive risk-taking on the part of those institutions or their creditors. For that reason, part of an effective risk-focused approach is the promotion of market discipline as the first line of defense whenever possible. Market discipline is enhanced whenever regulators take positive steps to ensure that investors and managers bear the consequences of their financial decisions.***"). *See also* Vice Chairman Donald L. Kohn, "Financial Stability: Preventing and Managing Crises," Exchequer Club Luncheon, Washington, D.C., February 21, 2007 *available at*: http://www.federalreserve.gov/newsevents/speech/Kohn20070221a.htm (*"The systemic-risk exception has never been invoked, and efforts are currently underway to lower the chances that it ever will be. For example, last December, the FDIC published an important proposal to improve its ability to resolve a troubled large depository institution in a least-cost manner. The FDIC proposal seeks to ensure that the largest banks and the FDIC have in place data and other management systems that would aid the FDIC in quickly identifying insured deposits and allow the FDIC to regulate the outflow of uninsured deposits while that identification was being completed. This proposal would, among other things, allow the FDIC to continue to protect insured depositors while making clear to uninsured depositors that they could suffer losses in the event of the failure of even a very large bank.* ***Thus, these changes would greatly enhance market discipline and help ensure that no bank is too big to fail.***"). *See* Remarks by Chairman Alan Greenspan, "Banking evolution", 36th Annual Conference on Bank Structure and Competition of the Federal Reserve Bank of Chicago, Chicago, Illinois, May 4, 2000, *available at*: http://www.federalreserve.gov/boarddocs/speeches/2000/20000504.htm (***"There are many that hold the misperception that some American financial institutions are too big to fail****. I can certainly envision that in times of crisis the financial implosion of a large intermediary could exacerbate the situation. Accordingly, the monetary and supervisory authorities would doubtless endeavor to manage an orderly liquidation of the failed entity, including the unwinding of its positions. But shareholders would not be protected, and I would anticipate appropriate discounts or "haircuts" for other than federally guaranteed liabilities."*). *See* Remarks by Vice Chairman Roger W. Ferguson, Jr., "Understanding Financial Consolidation," Securities Industry Association and the University of North Carolina School of Law, New York, New York, February 27, 2001, *available at:* http://www.federalreserve.gov/boarddocs/speeches/2001/20010227/default.htm ("*We recommend that the risks to individual firms and to the financial system could be reduced by stepped-up efforts to understand the implications of working out a large and complex financial institution.* ***Because no institution is too big to fail****, I believe that regulators should develop a clearer understanding of, for example, the administration of bankruptcy laws and conventions across borders; the coordination of supervisory policies within and across borders; the treatment of over-the-counter derivatives, foreign exchange, and other "market" activities in distress situations; the roles and responsibilities of managers and boards of directors; and the administration of the lender-of-last-resort function."). See* Remarks by Governor Laurence H. Meyer, "Controlling the Safety Net," 37th Annual Conference on Bank Structure and Competition of the Federal Reserve Bank of Chicago, Chicago, Illinois, May 10, 2001, *available at*: http://www.federalreserve.gov/boarddocs/speeches/2001/200105102/default.htm (***"A second priority for bank supervisors is to continue to develop procedures that make sure no bank is too big to fail in these senses: that stockholders can lose all, that existing management can be replaced, that uninsured creditors can suffer losses, and that the institution can be wound down and possibly sold, in whole or in part, in an orderly way."***).

20 . *See* Rebecca Christie & Craig Torres, *"Paulson, Bair Want System for Investment Bank Closure*", BLOOMBERG NEWS, June 19, 2008, available at: http://www.bloomberg.com/apps/news?pid=20601103&sid=aKo5giy3WnlM&refer=news ("We must limit the perception that some institutions are either too big or too interconnected to fail," Paulson said at the Women in Housing and Finance annual luncheon. "If we are to do that credibly, we must address the reality that some are.").

result of poor internal risk controls by their managements and even more inadequate safety and soundness oversight by the OCC, OTS, state banking regulators, the SEC[21] and the self regulatory Federal Reserve District Banks. Instead of seeking to uproot a market acceptance of moral hazard and employing the tools they have available to them, most regulators appear to have embraced 'too big to fail' as a policy response.

If confidence in private capital markets is to be repaired, regulators must make use of market mechanisms to force disposition or write-downs on troubled assets. subsequent burn-down-analysis must support the clearing of weak assets and weak institutions, regardless of size. If one is to believe that markets are efficient then one must rely on them to be such. That is to say that we must ensure that no enterprise can be considered or treated as 'too big to fail' and must devise the tools necessary to reclaim market authority. Instead of pretending that the monies provided to, as example, Citi will get them through the troubles, we should see the funds as a bridge to manage a least disruptive and least costly resolution, of an apparently failed institution. It is important and instructive to remember that President Franklin Roosevelt, in his first major action as President, showed courage and leadership when he announced a bank holiday to restore confidence in the banks. He then honestly explained the value of his action during his first "fireside chat". While it is similarly important to restore the public trust in the solvency of financial markets and institutions, the complexity and scale of non-depository financial intermediaries would not permit such a quaint approach.

The use of "TARP" monies for bank solvency has been a primary focus of investors and the media. There have been monumental regulatory changes that have been largely ignored. In combination these changes begin to truly create an environment in which the specter of "too big to fail" can largely be put back in the bottle, hopefully until the next hundred-year flood. These changes materially reduce two key risks to financial institutions – the risk of deposit or, in capital markets, liquidity runs and the systemic risks posed by counterparty failures.

Even with the Federal Reserve's mission to provide needed liquidity to any institution subject to reserve requirements and the existence of deposit insurance (up to $100,000) provided by the FDIC,[22] bank depositors feared that their banks might not have enough

---

21. Testimony of Henry M. Paulson before the Senate Banking Committee, Feb. 29, 2000, *available at:* http://banking.senate.gov/00_02hrg/022900/paulson.htm (*"In addition, we and other global firms have, for many years, urged the SEC to reform its net capital rule to allow for more efficient use of capital. This is the single most important factor in driving significant parts of our business offshore, so that our firms can remain competitive with our foreign competitors risk-based capital standards must become the norm. The SEC has made it clear that risk-based capital rules can be implemented only when the Commission is confident that firms employing value-at-risk models have robust credit and risk management policies in place. This means that needed net capital reform is likely to come only when the SEC is prepared to conduct these risk management examinations with its own staff or is confident that SROs have the capability to perform them."*). Ironically, on April 28, 2004 the SEC voted to eliminate the net capital rule for the five largest investment banks. Almost immediately the leverage of these investment banks began grow in multiples, sowing the seeds of their demise. *See* U.S. Securities and Exchange Commission, Open Meeting Agenda, Apr. 28, 2004, *available at* http://www.sec.gov/news/openmeetings/agenda042804.htm#item3.

22. *See* Federal Reserve District Bank of Cleveland, 2007 Annual Report at 24, *available at*: http://www.clevelandfed.org/about_us/annual_report/2007/Op_High.pdf?WT.cg_n=General;Content%20Type;Page%20Type&WT.cg_s=About%20Us;Annual%20Report;pdf ("The Depository Institutions Deregulation and Monetary

capital to meet depositor redemptions. This fear became reality when a bank run resulted in the collapse and seizure of Washington Mutual, the nation's largest thrift.[23] Recognizing the risks posed by panicked withdrawals of retail deposits and larger non-interest-bearing transaction accounts, the FDIC, in an emergency and temporary action, increased deposit insurance limits on interest bearing deposit accounts to $250,000, offered unlimited insurance on non-interest-bearing deposit accounts[24] And created a program to guarantee bank debt. As a result, until the temporary program expires, there is no rational behavioral or economic basis for bank deposit runs.

The presence of FDIC assistance suggests that the primary remaining systemic risk, which would prevent the resolution of large complex institutions, would result from counterparty risk consideration. Here too we have seen actions that should successfully reduce moral hazard issue. On August 6th, the FDIC put forward a *Notice of Proposed Rulemaking* The rule, once finalized, will allow them to request and receive all information they would require to manage the counterparty exposures of a "troubled" institution.[25]

Once the FDIC's rule on Qualified Financial Contracts (QFCs) is final, at least until the expiry of the temporary increases in deposit limits, there should not be troubled institutions that are either too large or too complex to be resolved . The FDIC can use any of its existing authorities to resolve institutions including "good bank"/"bad bank" resolutions where all counterparties whose aggregate exposures are appropriately collateralized would be moved to the good bank and all those whose exposures are under-collateralized would be moved to the bad bank. In these cases, the counterparty would become a general creditor of the estate. Although this strategy might cause a rush of

---

Control Act dramatically expanded the universe of depository institutions eligible to borrow at the discount window. As a result, the Federal Reserve assumed responsibility for meeting the liquidity needs of not only member banks, but also any institution subject to reserve requirements. The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) restricted Federal Reserve lending capabilities to potentially insolvent institutions. This act was designed to address perceived issues in discount window lending in the turbulent 1980s, when the Federal Reserve lent for extended periods to banks that eventually failed. In some cases, this lending helped provide uninsured depositors and other creditors sufficient time to remove their funds from a troubled bank, which increased the losses to the federal deposit insurance fund.").

23. Robin Sidel, David Enrich, & Dan Fitzpatrick, *WaMu Is Seized, Sold Off to J.P. Morgan, In Largest Failure in U.S. Banking History*, WALL ST. J., Sept. 26, 2008, *available at*: http://online.wsj.com/article/SB122238415586576687.html

24. FDIC Press Release, "FDIC Announces Plan to Free Up Bank Liquidity, Creates New Program to Guarantee Bank Debt and Fully Insure Non-Interest Bearing Deposit Transaction Accounts", Oct. 14, 2008, *available at*: http://www.fdic.gov/news/news/press/2008/pr08100.html

25. *See* FDIC, *Notice of Proposed Rulemaking*, FIL-75-2008, *available at*: http://www.fdic.gov/news/news/financial/2008/fil08075.html#body ("The proposed rule and appendix would require an institution in a troubled condition, upon written notification by the institution's appropriate federal banking agency or the FDIC, to produce immediately at the close of processing of the institution's business day for a period provided in that notification:

1. electronic files for certain position level and counterparty level data;
2. electronic or written lists of (i) QFC counterparty and portfolio identifiers, (ii) certain affiliates of the institution and the institution's counterparties to QFC transactions, (iii) contact information and organizational charts for key personnel involved in QFC activities, and (iv) contact information for vendors for such activities; and
3. copies of key agreements and related documents for each QFC.").

collateral calls, the calls should be manageable in conjunction with this overall capital plan.

This strategy suggests that the FDIC, in concert with Treasury and with other primary regulators, should use this window of time to resolve all institutions that it would choose to resolve in a more normal period..

Washing the Toxins out of the Banks

Rather than providing capital to the current financial market players, capital should be provided only after institutions have either sold or written down their troubled assets to fair market prices. This may be achieved by an open market clearing process. Liquidity problems are not only about capital but a lack of a market in which to transact. Therefore, by acting to arrange and by performing this function, Treasury would become a market "clearinghouse." Institutions that are solvent on a net basis should be able to receive the "good bank" portion of those failed and insolvent institutions resolved by the FDIC. The FDIC would seek recovery on the "bad bank" through either its normal "least cost" approach or Congress can approve a process similar to the Resolution Trust Corporation.

To achieve these ends, the Secretary of Treasury could, as example, require each primary federal safety and soundness regulator (Federal Reserve, OCC, OTS, and FDIC) to collect lists of assets that fit certain liquidity, collateral, and risk parameters from their regulated "troubled institutions."[26] The regulated institution would be required to provide detail of the cost basis, size of position, current mark, CUSIP (where available), and other supporting collateral documentation such as vintage, collateral, and most recent date of valuation. The primary regulator would then provide these lists to the Secretary, identifying the regulated institution only by an alphanumeric identifier.

Treasury would aggregate assets and, where duplication exists among the holders, pool them. The Treasury would then begin a process in which blocks of assets would be

---

26. Given the complexity in analyzing the balance sheets of the largest institutions, it appears sensible to use the definition of troubled institution promulgated in the FDIC Notice of Proposed Rulemaking. *See id., FIL-75-2008 available at:* http://www.fdic.gov/news/news/financial/2008/fil08075.html#body (See: "For purposes of the proposed rule, "troubled condition" means any IDI that:

1. has a composite supervisory rating, as determined by its appropriate federal banking agency in its most recent examination, of 3 (if the IDI has total consolidated assets of $10 billion or greater), 4 or 5 under the Uniform Financial Institution Rating System, or in the case of an insured branch of a foreign bank, an equivalent rating;
2. is subject to a proceeding initiated by the FDIC for termination or suspension of deposit insurance;
3. is subject to a cease-and-desist order or written agreement issued by the appropriate federal banking agency that requires action to improve the financial condition of the IDI, or is subject to a proceeding initiated by the appropriate federal banking agency that contemplates the issuance of an order requiring action to improve the financial condition of the IDI, unless otherwise informed in writing by the appropriate federal banking agency;
4. is informed in writing by the IDI's appropriate federal banking agency that it is in troubled condition for purposes of the rule on the basis of the institution's most recent report of condition or report of examination, or other information available to the institution's appropriate federal banking agency; or
5. is determined by the appropriate federal banking agency or the FDIC, in consultation with the appropriate federal banking agency, to be experiencing a significant deterioration of capital or significant funding difficulties or liquidity stress, notwithstanding the composite rating of the institution by its appropriate federal banking agency in its most recent report of examination.").

publicly listed for auction. Treasury, after creating a standardized policy in consultation with the primary regulators, could either list the entire inventory of each institution's "troubled assets" for sale or could offer a significant enough percent (10% or more) to determine a real market price. This process would reduce balance sheet exposures, instill renewed confidence of bank investors, and should reduce the excessive equity market speculation about bank solvency that has arisen as a result of opacity of bank balance sheet valuation assumptions.

The listing and solicitation of bids can be achieved through the use of print media or industry standard mechanisms such as Bloomberg. Qualified Institutional Buyers (QIBs) or "Qualified Purchasers" would be provided an inspection period to review collateral tapes, analyze the securities and provide a single sealed bid each.[27]

If the high bid(s) are sufficient enough to clean up the entire offered block then that would be the realized price to the buyer. Where the spread is sufficiently wide, perhaps more than a predetermined percent of the notional value of the security, Treasury might consider a policy of committing capital to improve the price realized by the seller up to the midpoint between the marked value and the accepted bid, though this would not affect buyers price or potential return While this approach would represent a loss to the Treasury it would result in what would certainly be a lower level of loss than otherwise realized.

If, as example, the high bid was not sufficient to clean up the entire offering, Treasury could then aggregate the highest bids required to fill the offer. All bids within a specified percentage of each other would be considered winning bids. If there were not enough bids to take the entire offer, the remaining securities would be remanded to the selling institution that would use the top bid as the current mark.

Upon completion of this process, regulators would have a clear understanding of the current condition of their regulated institutions capital positions.[28] Regulators could thus determine which institutions were viable and could set about providing them with direct capital.

Direct Capital into the Banking Sector

Once the balance sheets of banking institutions are clean, retail and institutional investors would be significantly more confident in the accounting statements of the banks and would be willing to purchase their common equity with an understanding that the banks

27. Note: Treasury should determine the eligibility criteria after consultation with the Securities and Exchange Commission.

28. *See Mason & Rosner February 2007*, *supra* note **Error! Bookmark not defined.**, at 36 ("At present, even financial regulators are hampered by the opacity of over-the-counter CDO and MBS markets, where only "qualified investors" may peruse the deal documents and performance reports. Currently none of the bank regulatory agencies (OCC, Federal Reserve, or FDIC) are deemed "qualified investors." Even after that designation, however, those regulators must receive permission from each issuer to view their deal performance data and prospectus in order to monitor the sector.").

would then become primary, effective, and efficient mechanisms for, and beneficiaries of, renewed economic stimulus spending. At that time, Treasury could begin to effect capital injections into banks with a standard fully standardized preferred equity co-purchase Program'. The goal of this program would be to raise capital ratios to a level adequate to ensure that banks could support the social and economic mission of lending.

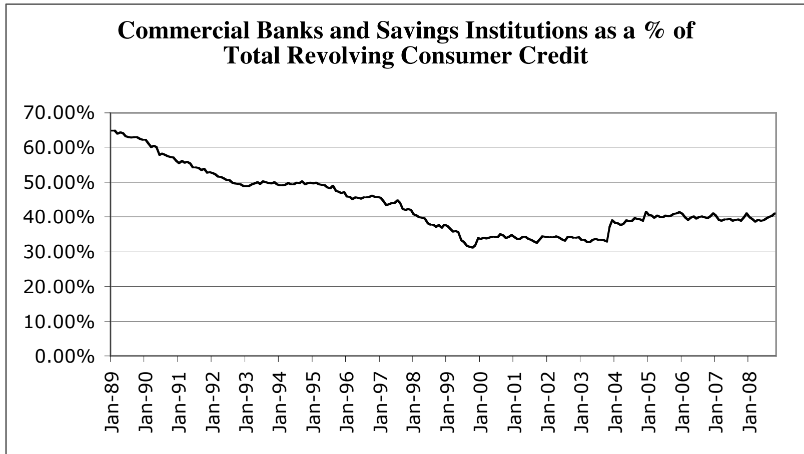
Banks trading at a predetermined price to tangible book value, perhaps 0.75, would be required to raise common equity sufficient to satisfy regulators. For each dollar they are able to raise in common stock the Treasury would commit to provide them an equal amount of preferred capital at a cost only nominally above the fed funds rate. For every dollar they raise above these limits, for the purpose of achieving stimulus-lending goals, Treasury will offer them capital at a further reduced rate.

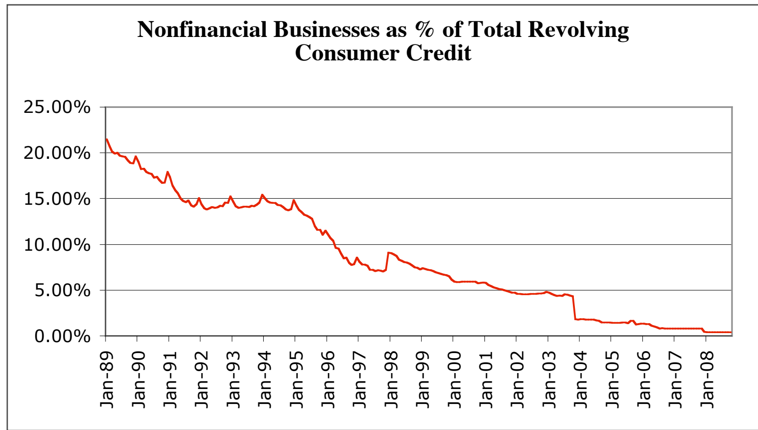
Any undersubscribed portion of the equity raise of "critically" or "systemically important" institutions, as defined in undisclosed consultation among primary regulators and Treasury, could be purchased directly by Treasury. In such cases Treasury would reduce the matching preferred capital by the undersubscribed portion. If the institution is later able to raise common equity and replace Treasury's holdings it may do so and receive the previously foregone preferred capital.

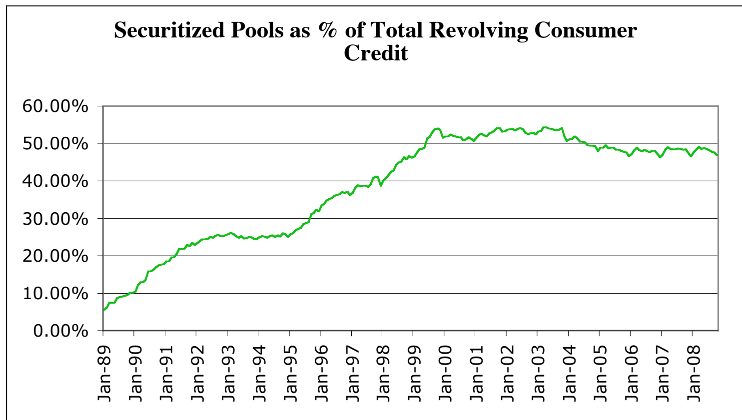
Step 3: Securitization: Key to Stabilization and Access to Capital:

In recent years we have witnessed the disintermediation of many of the banks' historic businesses. Securitization has shifted significant funding for many asset classes away from bank balance sheets and into the hands of capital markets participants. This change is the reason that we must now restart the securitization markets – if they are not functioning then there is no way to finance an economy that has previously been funded by the global capital flows through the less regulated capital markets.

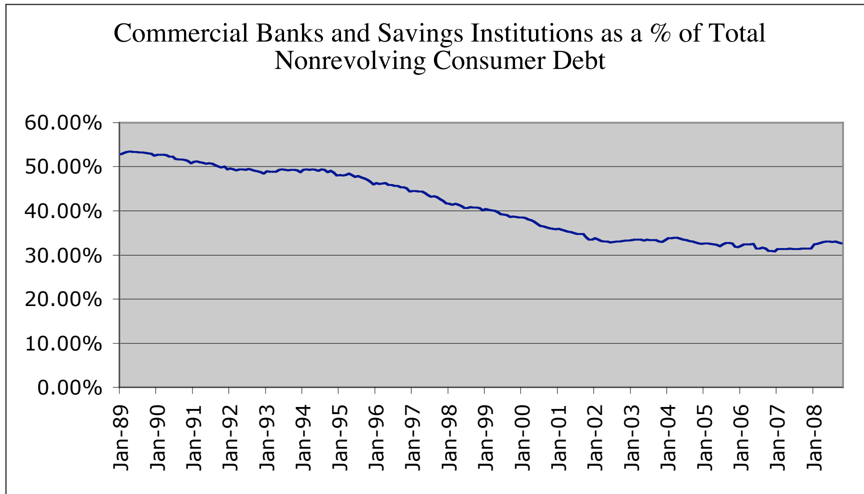
Given the importance of financial intermediation, neither the Fed nor any Federal regulator has ever had full authority over the tools of financial intermediation. The controls that we have assumed to have made our world quite different from the world of unregulated financial institutions in the 1920's are more assertions than they are supported by fact. As these charts demonstrate, securitization pools have replaced nonfinancial businesses to become a major holder of consumer revolving credit. Further damage to the willingness of investors to support those pools will have disastrous consequence. Given the urgency of the situation and the time it will take for the ABS market to repair, the Fed must provide enough liquidity to encourage private markets actors continue to purchase and hold these securities.

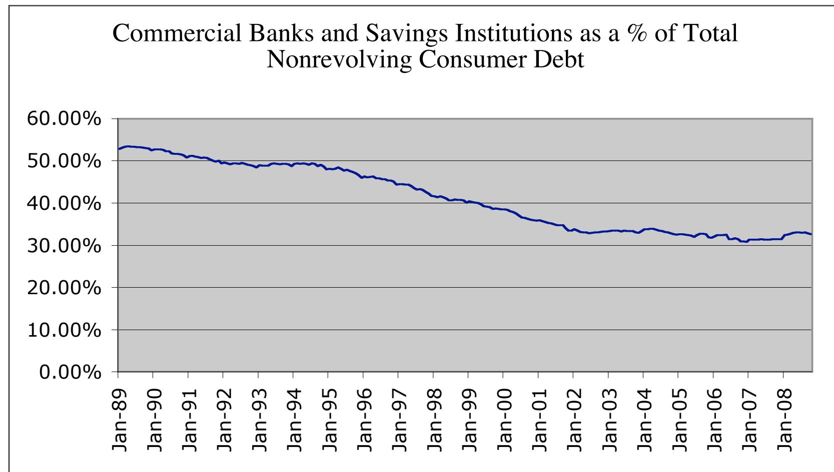

Commercial Banks and Savings Institutions as a % of Total Revolving Consumer Credit
70.00%
60.00%
50.00%
40.00%
30.00%
20.00%
10.00%
0.00%
Jan-89
Jan-90
Jan-91
Jan-92
Jan-93
Jan-94
Jan-95
Jan-96
Jan-97
Jan-98
Jan-99
Jan-00
Jan-01
Jan-02
Jan-03
Jan-04
Jan-05
Jan-06
Jan-07
Jan-08

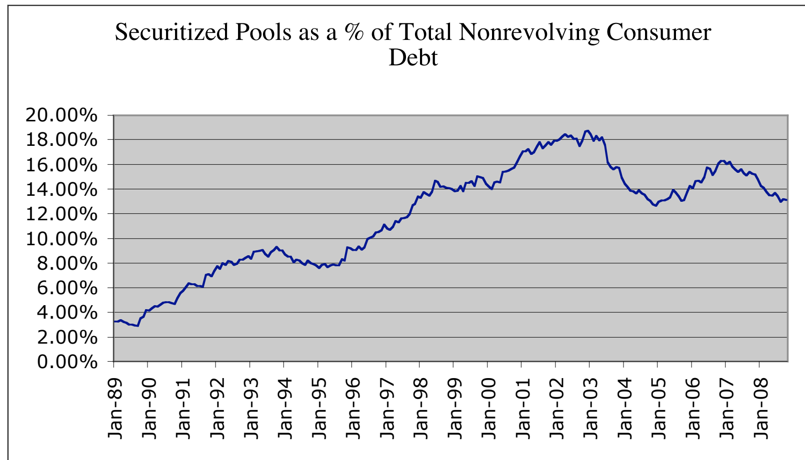

Nonfinancial Businesses as % of Total Revolving Consumer Credit
25.00%
20.00%
15.00%
10.00%
5.00%
0.00%
Jan-89
Jan-90
Jan-91
Jan-92
Jan-93
Jan-94
Jan-95
Jan-96
Jan-97
Jan-98
Jan-99
Jan-00
Jan-01
Jan-02
Jan-03
Jan-04
Jan-05
Jan-06
Jan-07
Jan-08


Securitized Pools as % of Total Revolving Consumer Credit
60.00%
50.00%
40.00%
30.00%
20.00%
10.00%
0.00%
Jan-89
Jan-90
Jan-91
Jan-92
Jan-93
Jan-94
Jan-95
Jan-96
Jan-97
Jan-98
Jan-99
Jan-00
Jan-01
Jan-02
Jan-03
Jan-04
Jan-05
Jan-06
Jan-07
Jan-08

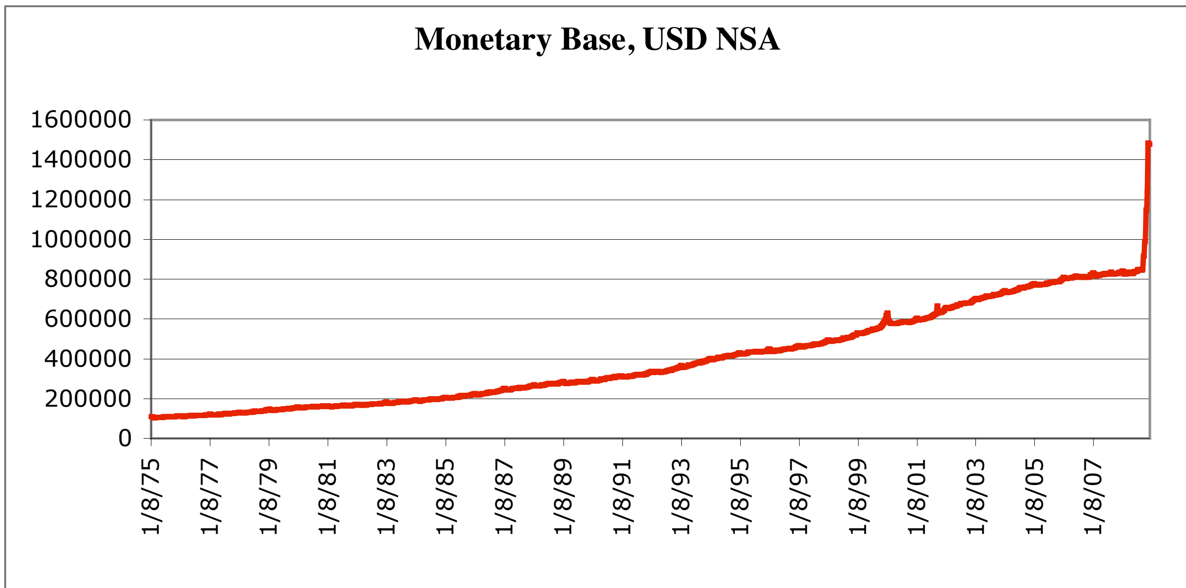
Moreover, given the collapse, bankruptcy, or consolidation and integration of many non-bank finance companies that had previously originated and large volumes of non-revolving consumer loans, such as mortgage loans, it is unlikely that the regulated banking world will, without massive liquidity, be able to replace those finance companies or securitized pools as holders of new debts.







Liquidity cannot find its intended target unless there are credible markets in which participants can foster financial intermediation and through which capital can be transmitted. Expanding the monetary base without a means of financial intermediation will result in little more than hoarding and pushing on a string.



There is an immediate need for regulators and policymakers to oversee the creation of a standardized market where securitized credit assets can be priced, valued and consistently evaluated by institutional investors that had previously been key intermediaries in capital formation yet had been subject to information asymmetries in the previous securitization

process. We must also, in recreating the structured market, clear outstanding legal questions about matters such as true sale.[29]

Just as the collapse of capital market funding of CDOs has resulted in the demise of the RMBS market and resulted in a rapid withdrawal of liquidity to the real economy, we stand at the edge of a moment in time where the same loss of market funding has recently choked off funding to the commercial real estate CDO market which, in turn, has resulted in a withdrawal of funding for CMBS.

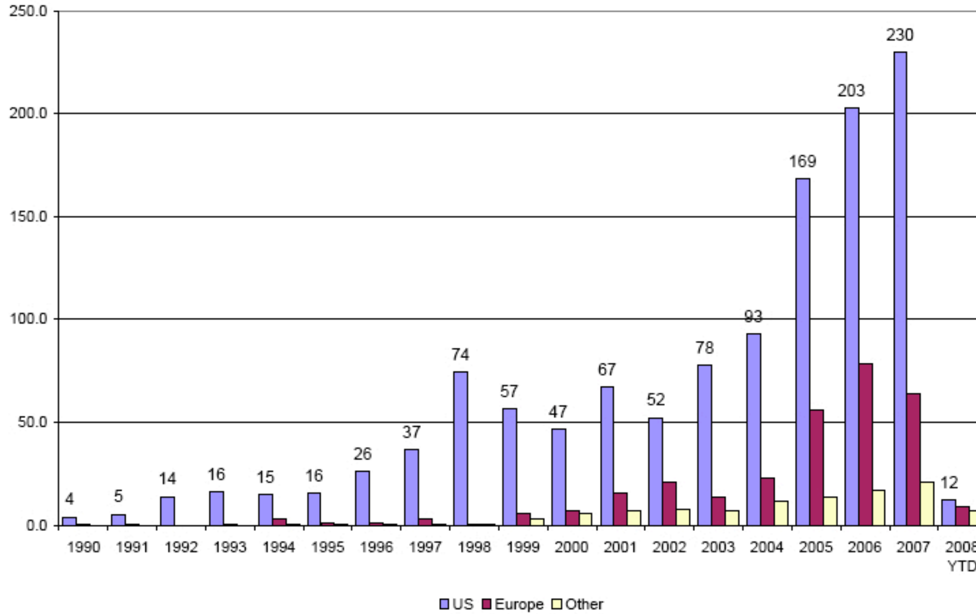
Commercial Real Estate CDO Issuance by Month:

	2000	2001	2002	2003	2004	2005	2006	2007	2008
January	0.0	0.0	0.0	0.0	0.0	527.9	290.0	600.0	73.2
February	0.0	1,499.6	421.3	1,519.2	50.4	2,698.1	2,901.3	2,498.7	0
March	0.0	697.3	1,000.0	850.0	1,808.6	462.8	4,240.9	4,999.2	35.2
1Q	0.0	2,196.9	1,421.3	2,369.2	1,859.0	3,688.8	7,432.2	8,097.9	108.4
April	0.0	0.0	972.0	75.9	690.9	1,426.2	2,467.5	1,710.2	0
May	0.0	1,456.9	1,792.3	134.7	0.0	869.4	2,075.7	5,818.4	5,292.2
June	48.7	0.0	510.3	493.5	414.3	3,565.3	2,179.0	8,986.0	5793
2Q	48.7	1,456.9	3,274.6	704.1	1,105.2	5,860.9	6,722.2	16,514.6	11,085.2
July	0.0	0.0	0.0	0.0	1,839.8	1,039.2	4,141.7	6,342.8	0
August	0.0	0.0	1,747.8	816.4	0.0	3,171.0	4,748.3	2,600.0	0
September	0.0	500.0	506.8	500.0	1,697.8	1,844.7	2,255.0	94.2	0
3Q	0.0	500.0	2,254.6	1,316.4	3,537.6	6,054.9	11,145.0	9,037.0	0.0
October	1,099.4	0.0	0.0	395.0	1,305.3	2,213.7	4,242.8	5,660.4	0
November	0.0	350.0	4,744.9	325.0	515.0	975.0	4,819.2	0.0	
December	0.0	0.0	1,196.4	495.2	305.3	2,929.6	5,452.9	1,905.4	
4Q	1,099.4	350.0	5,941.3	1,215.2	2,125.6	6,118.3	14,514.9	7,565.8	
Annual	1,148.1	4,503.8	12,891.8	5,604.9	8,627.4	21,722.9	39,814.3	41,215.3	11,193.6

Source: Commercial Mortgage Securities Association:
http://www.cmbs.org/uploadedFiles/CMSA_Site_Home/Industry_Resources/Research/Industry_Statistics/CMSA_Compendium.pdf

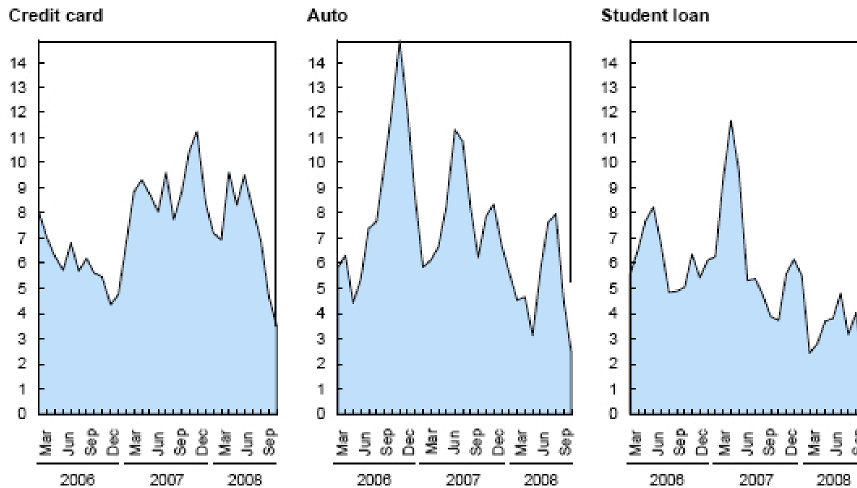
29. Countrywide recently settled. *See, e.g.,* David Greisling, *Deal to Help 21,000 in State Keep Homes*, CHICAGO TRIBUNE, Oct. 6, 2008, *available at*: http://www.chicagotribune.com/business/chi-mon_countrywide-settlementoct06,0,5680317.story ("The Company appears to have committed to modifying terms on loans held in mortgage trusts, without first repurchasing the loans. If the Company has the right to enter into a settlement and make commitments of and on behalf of third parties (investors of a supposedly legally isolated Trust) as part of the settlement then it appears this action may again open the unresolved legal question of whether a securitization could ever be legally treated as a "true sale" or "legally isolated", as opposed to a disguised financing. If the settlement is upheld and Countrywide is allowed to encumber those third parties then it seems reasonable to expect that all note holders in securitization trusts could argue that the original lender is, by definition, legally obligated to note holders as a source of strength.").

Commercial Mortgage Backed Securities Issuance:



Commercial Mortgage Securities Association: Commercial Mortgage Alert

There are many outstanding questions. Will the commercial real estate market be next to begin a deflationary cycle of deleveraging or will other consumer asset classes go first? As consumers continue to reduce their spending will we continue to see retail store consolidation and closings rise? Will that drive declining manufacturing orders and, in turn demand for warehouse space? Will that lead to further cut in office demand as middle management staffing levels are reduced? Will each of these steps exacerbate slowing consumer purchases as unemployment rises and consumers hold back on spending knowing that prices of goods and services are likely to continue to fall?



http://www.americansecuritization.com/uploadedfiles/RestoringConfidenceSecuritizationMarketsReport.pdf p.29

Part One – Creation of a Securitization "Clearinghouse":

The non-government supported secondary market for loans—the securitization market—has ground to a complete halt, and we must set about to fundamentally repair it. It cannot be merely another iteration of the same flawed market with the same skewed incentives.

Industry associations and trade groups, along with their member institutions, have dragged their feet on this subject and have offered incomplete and ineffective recommendations rather than real and manageable solutions.[30] The degree of financial damage that has resulted from many years of obvious problems, two years of non-functioning markets and poor "self-regulation" suggests Washington needs to push lobbyists aside and address the abdication of responsibility by Treasury and the SEC.[31] Neither government entity has shown acceptable levels of leadership in addressing the need for substantive and immediate action. While they may claim that they lack clear authority, they have both taken numerous extraordinary emergency actions without such authority.

These problems could be properly addressed with narrow legislation that creates an independent oversight board and authorizes Treasury to oversee a new standardized industry securitization "clearinghouse". In return for the capital support provided, Treasury has the ability to set the conditions under which recipients could receive capital and without setting any material conditions – participation in the new standards and new secondary market "clearinghouse" should be a precondition of the largest and most complex institutions.

The Treasury and the SEC could, as example, require industry participants to use a percentage of the capital provided them to invest in and build a third-party mutual origination platform. Treasury could issue super-voting shares to a government oversight board and dividend paying Class B shares to member institutions.

Treasury would delegate the voting of those shares to a regulatory oversight board that could be comprised of, as example, the OMB Director, the Assistant Secretary of Treasury for Financial Markets, The Director of the Division of Insurance and Research at the FDIC, the Director of Enforcement at the SEC, two elected by the Class B shareholders and perhaps a board member from the PCAOB or the PBGC.

---

30. American Securitization, ASF, ESF, SIFMA and ASF-Australia Offer Immediate, Coordinated Industry Response to the Market Crisis, Dec. 3, 2008, *available at:* http://www.americansecuritization.com/uploadedfiles/RestoringConfidenceSecuritizationMarketsReport.pdf ("In a global marketplace, investors and other market participants need consistency in the definitions of various products. For example, "subprime RMBS" and "non-conforming RMBS" have a different meaning in the US, Australia, UK and other countries.") I would point out the statement even fails to recognize that there remain no industry standard definitions, even within the US market, for "subprime", "delinquency", "default".) and ("").

31. *See, e.g.,* http://www.americansecuritization.com/ ("The American Securitization Forum (ASF) is a broadly-based professional forum through which participants in the U.S. securitization market can advocate their common interests on important legal, regulatory and market practice issues.").

After the first year of operation, Treasury could require that any regulated financial institutions seeking to securitize assets through the clearinghouse must purchase Class B stock from the Treasury at a price proportionate to its capital base and trailing year securitization volume. Class B shareholders will .

Class B shareholders would receive dividends that accrue annually. The accrued rate of interest would be reduced in each year based on loss rates for the remaining balance of the issuers' outstanding pools relative to the issues vintage and peer performance. Treasury would initially fund the "Clearinghouse's" administrative expenses and perhaps a reasonable and minimal guarantee fee. After the resumption of normal and stable markets they would be assessed out of the annual cash flows paid to Class B shareholders.

Although some might suggest that the creation of such a body would create too much regulation, such a structure would align the interests of the public with those of the industry. Issuers would be free to issue on a "private label" basis but, unless they conformed to standards pioneered by the "Clearinghouse," their securitizations would likely be less welcomed in the market and, as a result, more costly to issue.

The "Clearinghouse" would serve to develop industry standards, apply those standards in the purchase of collateral from member issuers, and enforce those industry standards. For example, the standards would include a single structure with a relatively uncomplicated tranche structure. This would replace the excessive complexity of current structures, which mimic the previously existing rating scale of the rating agencies and played a critical role fostering an environment of information asymmetry.[32] Real markets cannot develop where products are too complex for all but the most well financed and sophisticated investors. Instead, the structures should be thinly tranched. As example, they could even contain only senior, mezzanine and equity tranches. While chartered constrained insurance, bank and pension investors would generally remain constrained to purchase "investment grade" private-label securities, new standards should allow those constrained investors that are able to demonstrate sufficient internal operational management capability, could be allowed to purchase senior and mezzanine securities issued by the "Clearinghouse."[33]

Rather than, necessarily, creating a market or exchange on which these securities would trade, the "Clearinghouse" could, as example:

- ✓ Create collateral definitions (directly tied to loan level characteristic standards) of collateral it would purchase and securitize;
- ✓ Standardize the development of a legally defensible standard of "true sale"

32. Author's Note: I would suggest that this obviates the rating agency contention that they in no way are responsible for the structuring and development of structures they rate. If the rating scale is the a-priori or precursor and the structure is definitionally the a-posteriori it appears their argument is illogical.

33. The Author's detailed recommendations regarding regulatory oversight of NRSRO will be published in a forthcoming Journal.

- ✓ Create uniform industry Pooling and Servicing and Representation and Warranty contracts
- ✓ Create standardized modification terms and static and flow reporting requirements;
- ✓ Standardize industry definitions, such as:
    - o Prepayment;
    - o Delinquency;
    - o Default;
    - o Modification;
- ✓ Standardize, register, and publicly disclose all pre-issuance information detailing loan level data (not-including loan identifiers) on the collateral backing securities;
- ✓ Standardize and disseminate consistently formatted, publicly available disclosures of the pricing of pools;
- ✓ Create standardized disclosures of servicer advances;
- ✓ Publicly disclose formatted and standardized monthly servicer/remittance tapes.

This approach would provide a clear and consistent view of publicly available data. As a result, market reliance on rating agencies would be diminished. Moreover, because of the public availability of detailed information, there would be no reason the rating agencies would need to interact with issuers and, like in the single issuer debt market, securities issued by the "Clearinghouse" would be able to be issued and purchased by charter constrained investors without an initial rating. Instead, rating agencies market value would be determined by the predictive worth of their models in the secondary market.

Once set up, the "Clearinghouse" would be able to begin the process of securitizing loans. Securitized pools with guarantees would be less costly to the government than using government while those that were not guaranteed would likely carry risk premiums that reflecting the current economic uncertainty. Over time the pricing would begin to reflect a rational analysis of the collateral.

Section 3 Fiscal Stimulus and Capacity Building:

There is an urgent need to delever, merely rolling unrealized losses into the future is neither desirable nor is it a solution. While seeking to address creditor problems through artificial or non-market rates of interest would lower debt service burden it would not reduce actual debt burdens. To properly address the underlying problems will require actual principal write-downs, not artificial rate relief. Such rate relief will, if stemming the deflation is successful and market rates begin to rise, cause further and more fundamental economic and social problems – including decreased geographic mobility - as borrowers can not manage debt service at new and higher rates.

At the same time as add sufficient monetary stimulus to reduce the deflation resulting from deleveraging, we need to add significant fiscal stimulus to further insure against deflation. Making it easier for leveraged borrowers to manage their debts more easily by monetary inflation is critical but equally critical is supporting wage

growth at the bottom of the economic ladder. Without such growth borrower psychology will remain committed to the secular shift in favor of savings.

The lack of growth of real wages, relative to asset price inflation fueled the excesses of this past cycle – where individuals were increasingly reliant on the fruits of their investments as opposed to the fruits of their labors to survive and even believe they were prospering[34]. As more of the population relied on asset price appreciation we began to see the pyramid scheme fail by an overcrowding into the trade. Now is the time to retool.

To paraphrase Paul Volker[35], 'we have too may financial engineers and not enough civil engineers and the result has been bad bridges and worse financial products'. We need to invest in the bridges but, in an increasingly competitive global economy our interests would be best served by developing and investing in the creation of a highly skilled labor-force.

We have long heard about the need for an ongoing re-education of our workforce. Perhaps, given the difficulties faced by consumers as well as municipal, state and corporate budgets, we could create programs of tax credits that could support economic investment that will provide returns to labor and business. As example, the government could provide tax credits to businesses that support flex time for those employees that enroll in programs in key fields of education. Just as the race to land a man on the moon drove a growth in engineering and science programs, the Obama administration could, in a non-political manner, determine key areas of development.

A rational policy of state and municipal support could be created by providing tax credits to adult education students through expansion of low rate student loans. These tax-credits

---

See Rosner, Joshua, Housing in the New Millennium: A Home Without Equity is Just a Rental with Debt, Working Paper, June 29, 2001, *available at*: http://ssrn.com/abstract=1162456, at 3 ("Our concern lies in Mr. Raines comment regarding the "bending" of financial markets. This "bending" has materially altered the process of underwriting a mortgage. To fully understand the term a brief history of the housing/mortgage sector is required. In contrast to the resurgence in the U.S. economy, homeownership rates were flat for the entire decade of the 1980's. The homeownership rate had peaked at a historic high of 65.6 percent in 1980 from which it drifted back to 64.1 percent by 1991. Housing prices have risen faster than real wages since the 1970's and have made homeownership less 'affordable' to prospective buyers. Real prices for median priced homes increased 41% between 1960 and 1989. The majority of lower income and younger households were shut out of the housing market. Homeownership for low-income families with children fell by almost a third (from 39% to 27%). Homeownership among moderate-income households declined by 10%. Among families under 35, traditionally the largest segment of first-time homebuyers, ownership had also fallen dramatically, from 45% in 1980 to less than 38% in 1991. Flat savings rates, flat real wages, an increase in inflation adjusted cost of a down payment and rising debt to liquid assets made the amount of money required for down payment increasingly prohibitive… The creators of the strategy of the National Partners in Homeownership ('NPH') include, among others: HUD, Federal Deposit Insurance Company, Fannie Mae, Freddie Mac, the Mortgage Bankers Association, the American Institute of Architects, America's Community Bankers, the U.S. Dept. of Treasury and the National Association of Realtors. Their primary goal was "reaching all-time high national homeownership levels by the end of the century". This was to be achieved by "making homeownership more affordable, expanding creative financing, simplifying the home buying process, reducing transaction costs, changing conventional methods of design and building less expensive houses, among other means". It was almost unprecedented for regulators to partner this closely with those that they have been charged to regulate.").

[35] The Subprime Crisis and its International Consequences - What happened and How to avoid Similar Crisis? An American-European conference organized by Brookings, the Institut Montaigne and Institut de l'entreprise, April 4, 2008, http://www.institutmontaigne.org/evenements-en-partenariat-54.html

could be structured to allow students enrolled at state universities to deduct, against household income, up to 50% of the cost of the loans. Furthermore, the plan could be expanded to provide greater tax-deductions to allow individuals who, after completing their program, accept a job in an 'area of need' (such as teaching in an inner city school, engineering in alternative energy fields, civil engineering...)

Further tax credits that could provide significant stimulus could include corporate tax deductions for businesses that invest in re-tooling facilities and auto fleets to new standards of energy efficiency.

I offer these as examples. With discussion of infrastructure spending and significant focus on monetary inflation it appears that not enough attention has been paid to the vital importance to reengineering our workforce to be the globally entrepreneurial, advanced and competitive work force it once was.

History Suggests We Must Inflate Aggressively and Quickly:

Market pundits and policymakers regularly suggest that we are near an end to the crisis and that the current crisis is very different from that of the early 1930's. Others argue that, unlike that prior period, we have a better understanding of the causes and a better understanding of the failures of policy that caused that prior depression to endure for so long. "Unfortunately human memories seem to lack the qualities of tenacity necessary for self-preservation. The passage of a cycle of time seems to obliterate all recollection of former experiences…The adoption of laissez-faire produced a state of mind opposed to all interference and the legion of swindlers and fly-by-night stock jobbers operating in all lands grazed unmolested upon green pastures". This time might not be so different after all. While things are certainly never precisely as they had previously been, if one merely substitutes the word "stock" for the word "housing", and broaden the notion of capital markets to include securitization markets, the parallels become all too clear.[36]

That said and to be sure, significant differences in the absolutes exist. Deposit insurance has greatly minimized the risk of meaningful depositor losses, unemployment insurance will reduce the suffering, labor rights assure that rates of unemployment will never reach Depression levels and it would be unthinkable for mortgage default rates to reach depression levels. That said, even with greater investor protections today, consumer debt levels, are higher, savings rates are lower, CPI is now falling at rates unseen since the Depression, capital market underwritings have fallen off at paces unseen since that period and it is likely that commercial and consumer defaults will reach post-depression highs bringing further increases in unemployment. Although comparable data does not go back

36. *See id.* at 160 ("The major effect of the stock market collapse may be said to have been and investment, or capital, deflation, just as the boom was an investment inflation. An investment deflation, or a deflation of capital values and capital assets, is a much more prolonged process than a commodity or commercial credit, deflation. There was a serious deflation of commodity prices, it is true, but it would not have been so pronounced had there not been accompanying investment deflation to aggravate it. The industrial system is able to adjust itself to, and to react from, a deflation of commercial credit and a decline of commodity prices much more rapidly and readily if these are not associated with any large deflation of investment credit and of capital values.").

to the 1930's, Federal Reserve Flow of Funds data demonstrated that even with the rapid appreciation and low rates of interest, owner's equity of as a percentage of home value has fallen from over 70% in 1960 to slightly more than 45%.

The Great Depression – We Waited Too Long

Excessive speculation in the late 1920's was largely fomented by central banking policies that provided easy money in an effort to manage our way out of the economic depression of 1921. Easy money policies in the late 1920's drove widened public participation in the stock markets and, the inflation was not seen in increases in the money supply but through a massive increase in money-substitutes.[37] The increase in speculative capital drove excessive funding of commercial and industrial expansion, resulting in an oversupply of capacity . It also created a boon to the non-regulated financial sector through increasing allowance of leverage in margin accounts and leveraged investment schemes.

In an effort to reduce leveraged speculation in the stock market, the Fed increased the discount rate from 3.5% in January 1928 to 6% in August of 1929.[38] Even though previous loose money policies had resulted in years of mal-investment, the tight money program is usually blamed for precipitating the crash of 1929. The crash of 1929, in turn, is frequently cited as the driver of tightening credit and the subsequent deflations that comprised the Great Depression.

As Chairman Bernanke observed, funding markets ceased to operate effectively in late 1929 and "the effects of this credit squeeze on aggregate demand helped convert the severe but not unprecedented downturn of 1929-1930 into a protracted depression."[39] The public became distraught when it learned that the U.S. government acted too late and had lost the power to reverse the decline.[40]

---

[37] Murray N. Rothbard, America's Great Depressions, Fifth Edition, p.93 available at http://mises.org/rothbard/agd.pdf (To generate the business cycle, inflation must take place via loans to business, and the 1920s fit the specifications. No expansion took place in currency in circulation, which totaled $3.68 billion at the beginning, and $3.64 billion at the end, of the period. The entire monetary expansion took place in money-substitutes, which are products of credit expansion.)

38 . "The Discount Rate Controversy Between the Federal Reserve Board and the Federal Reserve Bank of New York", Nov. 1930 [hereinafter *Discount Rate Controversy*], *available at* http://fraser.stlouisfed.org/docs/meltzer/bogsub110130.pdf, at 34,

39. Ben S. Bernanke, Non-Monetary Effects of the Financial Crisis in the Propagation of the Great Depression, NBER Working Paper 1054, 1983 [hereinafter *Non-Monetary Effects*], at 259, *available at* http://fraser.stlouisfed.org/docs/MeltzerPDFs/bernon83.pdf

40. Seldes, Gilbert Vivian, THE YEARS OF THE LOCUST: AMERICA 1929-1932 (Little, Brown, and Company, 1933), at 219 ("The special character of the period from the end of 1931 to the midsummer of 1932 is this: that we reacted to the thing that was happening, which was deflation, not grimly as we had until the Moratorium, with the feeling that things were getting worse and would continue to get worse because nothing was being done and suffered a growing irritation because what was being done, in the name of counter-deflation, was so laggard and halting and ineffective. We broke down mentally and nervously because we began to believe that although we had the will to struggle, we had lost the power; we began to fear that we had started our march forward too late").

As a result of the contraction, between 1929 and 1932 many banks and non-regulated financial institutions that had been involved in speculation failed.[41] Only one of every six financial institutions that failed was in the Fed system.[42] While the absolute number of financial institution failures, even relative to the total, is high it is important to consider that even during the cyclical upswing of the Roaring Twenties 2 to 3 percent of banks failed annually. Several factors were at play, including: very low legal barriers to entry, a lack of economic viability of some institutions, and the fact that "many assets were highly illiquid" so that "in a run, fear that a bank may fail induces depositors to withdraw their money" and "thus, the expectation of failure, by the mechanism of the run, tends to become self-confirming."[43] Interestingly, bank failures didn't occur in an ongoing and regular process but rather in "short spasms"[44] and they were most often precipitated not by the reality of an institutional insolvency but by bank runs based on an assumption of insolvency.

Although the imbalances in the economy of the 1920's and the leverage and speculation that drove them are easy to recognize with hindsight, at the time it appeared to many that the contraction was tied more to a breakdown in confidence than to fundamental economic problems. In November 1929, President Hoover stated "Any lack of confidence in the economic future or the basic strength of business in the United States is foolish". [citation needed] For more than another year he suggested that and a year later continued to suggest, "economic depression cannot be cured by legislative action or executive pronouncement". [citation needed] Between 1929 and 1931 Washington continued to argue that a loss of confidence was the root of the crisis and confidence was the solution.

By late 1930 this view had reached its nadir with several states issuing proclamations creating "Confidence in Business Week."[45] While Washington tried to "talk up" confidence, the public was becoming impatient. On October 18, 1930 an editorial appeared in the *New York Times* that called for a ban on short selling.[46] Instead of taking

41. *See, e.g., Discount Rate Controversy*, *supra* note 38 ("Security loans of member banks declined somewhat during this period, but there was a very rapid increase in the speculative activity and in broker loans, supplied mostly by non-banking lenders").
42. Seldes, *supra* note 40, at 112.
43. *Non-Monetary Effects, supra* note 39, at 259.
44. *Id.* at 257.
45. "Hard Times (New Style)", Time Magazine, Monday, Nov. 03, 1930, available at: http://www.time.com/time/magazine/article/0,9171,882360-4,00.html
46. New York Times, Saturday Editorial ,"SHORT SELLING", October 18, 1930, P.12, available at: http://select.nytimes.com/mem/archive/pdf?res=F00E1EFD3A5C11738DDDA10994D8415B808FF1D3 (See: "With trade depression continuing in spite of recent assurances that it would surely end with arrival of Autumn, and with the stock market also falling below the prices reached in last Summer's drastic downward readjustment, it was not perhaps surprising that search for something peculiar and abnormal in the way of cause should have begun. The average man does not apply severe logic in his reasoning on such matters. It was at least a convenient supposition that business must be hesitating because of the bad stock market, and Wall Street itself had been reporting, every day, that "bear selling" had emphasized the market's unsettlement. Hence the demand from irritated watchers of the situation that the evil influence of such stock market operations be ended by suspension or outright prohibition of "short sales." Such action is undoubtedly possible. Mr. Untermeyer correctly states that the Stock Exchange itself "has it within its power to prevent or restrict short selling." Yet even so hostile a critic as he has heretofore been of Stock Exchange machinery is careful to add that whether such action would be advisable "is quite another thing." The stock Exchange authorities have given public warning that the speculative seller of stocks whose purposes were shown by deliberate circulation of

real and concrete actions Washington largely continued with its promise that "prosperity is just around the corner" and that " we have now passed the worst and with continued unity of effort we shall rapidly recover."[47] Just as real and high-powered nominal money stock did not increase dramatically during the growth of the bubble it remained expansionary, supported by low interest rates to try and resuscitate the economy after the bursting of the bubble and yet the velocity and money multiplier fell steeply.

By the end of 1930, there were regular and growing calls to make housing the centerpiece of a recovery. One commenter noted:

> make housing a ladder industry; each half year of the depression found more and more people certain that housing was the cure; H.G. Wells embodied the proposal in his voluminous story of the Work, Wealth and Happiness of Mankind; the President gave the idea his heartfelt blessing and manufacturers of all materials which go into the American house were banding together to fight the motor car, making a new house as desirable as a car had been."

The commenter also noted:

> It was true that mortgages were being foreclosed and homes were being lost; but the manufacturers of houses… were enthusiasts for the new idea, and with them stood the makers of brass and copper pipe, of furnaces, glass, lumber, electrical installations and the like. What none of them seemed to know at the time was that credit was contracting and that money was not available to start the wheel rolling.[48]

Finally, almost two years after the beginning of a crisis that Main Street seemed to recognize but that Washington did not, the Hoover Administration awoke. By late 1931, after a false expectation of recovery led the Fed to increase rates and cause another round of bank failures, Hoover recognized the need to abandon the approach of his Treasury Secretary, and former banker, Andrew Mellon. In December he presented a plan to create a new program to address bank solvency and on January 22nd 1932 the Reconstruction Finance Corporation was created and given the ability to borrow up to $2 billion from the Treasury to assure the survival of the financial and railroad industries. A month later the New York Stock Exchange all but banned short selling.[49]

---

disturbing rumors would be severely disciplined. But they too have declared through their president that since "normal short selling is an essential part of a free market for securities," prohibition of such sales "might result in the destruction of the market," and would therefore, in any case "too high a price to pay for the elimination of the few who abuse this legitimate practice." President Hoover lately talked the matter over with the Stock Exchange authorities; but the White House version of the interview was careful to point out that the Government had no idea of interfering with policies of the Stock Exchange.").

[47] John T. Woolley and Gerhard Peters, The American Presidency Project [online]. Santa Barbara, CA: University of California, available at http://www.presidency.ucsb.edu/ws/?pid=22185

48. Seldes, *supra*, note 40 .at 69, 113.

49 . *See id.* ("The Exchange restricted brokers from lending customer stock to shorts without obtaining written permission from the customer that his stock may be used in that manner.").

While these actions were late in coming, there was still hope that they would provide relief. Unfortunately, it appeared that they could not.[50] Banks remained tight with their credit and used incremental monies to build up their impaired reserve ratios.[51] Banks had several rational reasons not to lend. They argued:

- Creditworthy borrowers were not interested in borrowing in an environment in which prices were falling;
- There was no reason to make risky loans to weak and overleveraged borrowers or to finance questionable projects
- There was no reason to lend into an environment of uncertainty about the tax policies, in the wake of the Revenue Act of 1932 and anticipation of the new Congress and a new President coming to Washington in January 1933[52]

One commenter noted that things only seemed to get worse:

> The years from 1929 to 1933 were, for America, a succession of breaking idols and abandoned faiths, some of them the notions of willful children, some deeply ingrained in the character of the nation ...The Law: District Attorney Keyes of Los Angeles was sentenced to San Quentin for five years for accepting bribes… The Banks: not only for their disastrous failures, but for their debasement of the banking function into security selling and for permitting kiting and other doubtful practices to favored clients… Bank Statements: By agreement with the Government, banks placed an artificial value upon certain securities they held. Those who did not know of the agreement assumed that the values were actual.[53]

---

50. *See* http://www.u-s-history.com/pages/h1523.html ("Despite some initial success, the Reconstruction Finance Corporation never had its intended impact. By its very structure, it was in some ways a self-defeating agency. The law required full transparency — the amounts of all loans and the names of the recipient companies were made public. This requirement had the unfortunate effect of undermining confidence in the institutions that sought loans.").
51. Banking and the Business Cycle p.163
52. *See* Seldes, *supra* note 40, at 169 ("The next phenomenon, increase of general business through an increase of credit, did not occur so promptly. I will not go into the details of the financial expedients by which the Federal Reserve and the Reconstruction Finance Corporation interacted. The essence was that the Fed piled up vast sums of money, in the form of credit available to banks, and that the RFC stood ready to lend banks money to tide them over difficulties; the banks which needed help went to the RFC, but the solvent banks did not go to the Fed to use the credit waiting for them. If this were purely a financial choice, it would have had no significance. It was, however, the very foundation of industrial recovery that the banks should lend money freely; for that, all the reconstruction program had been arranged. And the banks did not lend. For a long time the banks hesitated because they could not know what Congress would do about taxation. A country of business men felt the necessity of balancing the budget, a business ideal; the country went back to its almost forgotten principle of living within its income, cutting down expenses and trying hard to raise necessary funds. To the banks the thing that mattered was where the taxes would fall; if they fell on corporations and manufacturers, or were doubled for the upper brackets of the supertax, the effect on business might be evil. If congress failed to cut expenses enough, the effect on foreign observers might be just as bad; instead of following the strict scheme, Congress proposed inflation of currency instead of expansion of credit, the banks which had loaned good money would get back bad money. In these uncertainties, the masters of money did a simple thing: they hoarded. Only for great banks the name was not considered dignified: they "remained in a highly liquid position." Moreover, they swore that no respectable requests were made; they could not lend on bad security nor for projects which were obviously doomed to failure. In brief, the unuttered criticism of the bankers had a curiously radical tone: the Government had gone about creating confidence by creating credit; but credit was of no use unless confidence came first. The financial structure of the country had been saved-and now had no enterprise worthy of financing, because the industrial structure was still unsteady.")
53. *See* Seldes, *supra* note 40 at 276.

Real action began, in January of 1933 as the newly confirmed President Roosevelt immediately declared a bank holiday to close the sick banks and restore confidence in the healthy ones.[54] This action was followed by other dramatic steps including: (1) Bank Conservation Act in March; (2) the creation of the Home Owners Loan Corporation to support homeownership and stimulate the building industry; (3) the extension of loans to closed building and loan associations; (4) the organization of local mortgage companies to support bank lending; (5) the creation of the Deposit Liquidation Board to encourage liquidating agents of failed banks to borrow, for the benefit of depositors, up to 50% of the deposits value of a liquidating institution; (6) the creation of the Federal Deposit Insurance Corporation to guarantee and insure customers' deposits; and (7) the Gold Reserve Act that, by raising the price of gold from $20.67 to $35, devalued the dollar in an attempt to generate inflation.[55]

Roosevelt pushed the Emergency Banking Act, which expanded the RFC to allow the government to buy preferred shares. Banks remained unwilling to sell preferred shares to the RFC until the RFC informed the American Banker's Association that if they refused to start lending the government would begin making direct loans. Lending activity had not fully materialized by 1935 even though the RFC held nearly one-third of bank stock value.[56] Such is the slow the nature of debt deflations.

While the "New Deal" and all of its programs of government spending and support are believed to have provided effective stimulus to repair the economy such a view may be revisionist. Conditions in 1936 still drove Landman and Willis to observe that:

> a measure authorizing the Federal Reserve Banks to make direct industrial loans to enterprises which have been unsuccessful and cannot obtain loans elsewhere has been one consequence (June, 1934)… We have transferred central banking powers to the Treasury and now we contemplate a political central bank owned and operated at Washington. Enough to say that we have substituted for a system of lending and financing based on an ability to maintain independence and self-support, a system based in every branch of its being upon the furnishing of proof of its inability to be self supporting. The change has been defended even by some who admit its character on the ground that it prevents needless or extreme suffering, kept our existing organism of finance and business alive and thus

54. President Roosevelt, Radio Address "On the Bank Crisis", Mar. 12, 1933 available at: http://www.fdrlibrary.marist.edu/031233.html ("…*These state banks are following the same course as the national banks except that they get their licenses to resume business from the state authorities, and these authorities have been asked by the Secretary of the Treasury to permit their good banks to open up on the same schedule as the national banks. I am confident that the state banking departments will be as careful as the National Government in the policy relating to the opening of banks and will follow the same broad policy. It is possible that when the banks resume a very few people who have not recovered from their fear may again begin withdrawals. Let me make it clear that the banks will take care of all needs -- and it is my belief that hoarding during the past week has become an exceedingly unfashionable pastime. It needs no prophet to tell you that when the people find that they can get their money -- that they can get it when they want it for all legitimate purposes -- the phantom of fear will soon be laid. People will again be glad to have their money where it will be safely taken care of and where they can use it conveniently at any time. I can assure you that it is safer to keep your money in a reopened bank than under the mattress.…*").

[55] J. Franklin Ebersole, Banking, in Current Economic Policies, p.126, Henry Holt & Company, December 1934

[56] C. A. Phillips, T.F. McManus, R.W. Nelson, BANKING AND THE BUSINESS CYCLE: A STUDY OF THE GREAT DEPRESSION IN THE UNITED STATES, ([Publication City]: The Macmillan Company, March 1937),

> maintained a basis for real and rapid recovery. Has it done so? There can be no doubt that the operations of the numerous government recovery institutions, loan corporations, bond guarantees, treasury underwritings, subventions and subsidies of the past two years have prevented many persons and institutions from going at the wall at once to the wall. But whether such success has been had in this direction has been ultimately beneficial to the community or to any one in it may be gravely doubted.[57]

While our eyes see the current world in living color and not the sepia shades of an unimaginable and seemingly unlivable past, the current economic turbulence was fostered by easy money policies leading up to the year two-thousand (Y2K), stimulus provided after the dot.com bubble burst, and further stimulus after 9/11. Just as easy money in the 1920's drove speculation in the stock market, the easy money in this cycle drove speculative credit through the securitization markets to many real economy assets - including housing. A combination of low interest rates, low down payment products, and perverse tax incentives created an ephemeral 'wealth effect' tied to home price appreciation.[58] Record levels of refinancing drove record levels of home equity extraction, which in turn drove increased consumer leverage.

When, after the Central Bank increased interest rates and caused a contraction of available credit, the housing market crashed it took with it many fortunes. Like 1929, it was the breadth of the participation rates in the stock market crash that kicked off the contraction.[59] The greater significance of the crash was not these losses to investors, but that the entire economy had become reliant on the growth in non-monetary credit that drove this expansion of consumer driven consumption. Just goods and service providers were, in the 30's, left with excess supply that is neither economic nor productive, so too are they today. Our lesser reliance on the domestic production of goods than services may make the deflation, outside of construction, less severe and the downward adjustment of prices perhaps more gradual than might otherwise occur. Unfortunately, the lack of a viable manufacturing capacity and the higher wage regime, relative to our trading

---

57. J.H. Landman and H. Parker Willis, "Starting Roosevelt's New Deal, America's Bank Holiday and After," in WORLD EPOCHS, VOL. TWELVE, NOTABLE NARRATIVES OF THE CHIEF CLIMAXES OF THE WORLD DEPRESSION 1927 TO 1936, (The United States Flag Association, 1933), at 383.

58. Consider the effect speculation on house price appreciation had on consumption relative to the effect of speculative stock appreciation. For example, *see* C. A. Phillips, T.F. McManus, R.W. Nelson, BANKING AND THE BUSINESS CYCLE: A STUDY OF THE GREAT DEPRESSION IN THE UNITED STATES, ([Publication City]: The Macmillan Company, March 1937), at 159 ("It should be apparent that the higher prices for stocks during the boom, and the greater realized profits, were more strictly products of expanding bank credit and a higher velocity for that bank credit, than any rational discounting of future corporate earning power. Working through the securities market, however, some part of the newly created credit increased consumer demand and thus had an effect upon productive activity.").

59. *See id.* at 160-61 ("The losses suffered in the stock market crash of 1929 affected a greater number of American people than had any previous collapse; the savings of a lifetime were rudely swept away for great numbers of the rank and file, and many New Ear millionaires saw their fortunes vanish almost overnight…The shock to confidence wrought by the stock market panic was promptly reflected in the capital market, and the volume of new issues shrank drastically. The new capital flotation in this country dropped 30% from 1929 to 1930, and in the following year declined an additional 60 percent. The total of corporate bond issues for the whole year 1932 was less than half he average monthly figure for 1929.".).

partners, may make it more difficult (for reasons even beyond politics) to stimulate *productive types* of inflation.

In an effort to reduce leveraged speculation in the housing market, the Fed began a process of increasing the discount rate from 2.5% in June 2004 to 6.25% in June 2006. Just as Fed tightening in the fall of 1929 induced margin calls, by mid 2005 it was becoming evident that the Fed was targeting the broadest beneficiary excess liquidity in the securitization and housing markets and, in turn, the consumer.[60] Residential mortgage debt outstanding had grown from $5.5 trillion in 2000 to $11.2 trillion by the end of 2006 and tax policies encouraged borrowers to fund other shorter terms obligations, such a automobile debts and other consumer debts, through the growth of mortgage balances. This massive inflation of credit in the real economy drove unprecedented demand for retail goods and services and, in turn, commercial goods and services.

By late 2005 the Fed's actions were clearly beginning to hit the housing market and the risk of catastrophic and deflationary results were becoming apparent:[61]

> When the third-quarter mortgage delinquency data is released (mid December), investors will recognize that the cycle has begun to turn. Since these increases will be driven by higher energy prices and hurricanes many will choose to see the increases as aberrational. We would caution this data is almost certainly the first leg in what will become a declining environment for consumer credit quality. Seasoning, higher ARM exposure, and increasing subprime originations finally appear to warrant the concerns that have been unwarranted as home appreciation rates were robust.[62]

Unfortunately, neither the Fed nor the rating agencies responded preemptively to the seriousness of the situation.[63]

---

60. *See* Josh Rosner, Housing, *"Code Orange: Historic Performance Does Not Guarantee Future Results",* MEDLEY GLOBAL ADVISORS, May 17, 2005 ("In June of 2001 I wrote that "a large portion of the housing sector's growth in the 1990s came from the easing of the credit underwriting, appraisal and lossmitigation processes. I concluded, "If these trends remain in place, it is likely that the home purchase boom of the past decade will continue unabated." It now appears there is an increasing risk that these trends may be reaching their limit."").
61. *See* Josh Rosner, *"Housing And Mortgage Finance: Chicken Little On Wall Street",* MEDLEY GLOBAL ADVISORS, Nov. 16, 2005 ("There is no question that we are at the front end of slowing national appreciation rates (though ironically penetration of these products in some new markets will support appreciation). Due to the large amounts of investor held "phantom inventory," investors may be incorrectly interpreting the potential inventory environment. With a historically unprecedented 12% or so investor share in the 1H05 there is the potential that when rates of returns on investment properties slow many of those properties could come to market. This move to sell would also be incrementally increased by the decreasing willingness of lenders/servicers to mitigate bad loans as interest rates rise and appreciation slows, thus increasing default and foreclosure exposures. As we have previously stated (MGA "Home Is Where Your Wallet Is" 11/1/05), we continue to expect consumer mortgage credit quality to show deterioration in the third quarter (largely from energy prices and Hurricane Katrina) and expect that it will continue to rise from there… To assume that a slowdown in the housing market will quickly translate in unmanageable losses, panicky regulators, or a disallowance of new product offerings is unrealistic. As long as investors expect a level of credit quality deterioration worse than what we actually see, which is more in the hands of the credit rating agencies than the regulators, even liquidity in the MBS/ABS market should remain adequate although tighter.")
62. Josh Rosner, *Home Is Where Your Wallet Is*, MEDLEY GLOBAL ADVISORS, Nov. 1, 2005.
63. Evelyn M. Rusli, *Fed Moves To Calm Investor Panic*, FORBES.COM, Aug., 21, 2007, ("The public has also expressed skepticism about the Fed, which had assured investors earlier this year that the subprime crisis was contained.")

By fall of 2006, rising levels of early payment defaults caused investors to worry that poor underwriting standards threatened their investments. The same banking and investment banking firms that had previously extended enormous warehouse lines to non-regulated mortgage originators aggressively began pull those warehouse lines resulting in massive institutional failures as well as decreased mortgage funding and mortgage originations.[64] Just as a reduction in available margin in 1929 caused the failure of a large number of non-regulated financial institutions, by late 2006 the failures of non-regulated financial institutions was in full swing and the structural changes which threatened to create an atypically dangerous impact to the real economy continued to be misunderstood by regulators and policymakers.[65] "Because markets for financial claims are incomplete, intermediation between some classes of borrowers and lenders requires non-trivial market making and information-gathering services" but the withdrawal of these lines resulted in the breakdown between investor and mortgage originator and capital and borrower.[66]

---

64. *See* The Mortgage Lender Implode-O-Meter, *available at* http://ml-implode.com/index.html#lists.

65. *See* Josh Rosner, "*Not Your Father's Housing Cycle*", MEDLEY GLOBAL ADVISORS, Nov. 17, 2006, at 10 ("The ISSUE is whether over the reliance of each upon the other fostered a mispricing of risk and WHETHER structural changes created on the cyclical upswing be tested in a downturn. Ultimately, the unfolding housing and mortgage market story is not one of regional economic activity, as housing cycles have historically been, but rather a financial market confidence game. Unlike prior housing cycles in which prices were primarily driven by regional commercial activity and demographics, the current cycle has been driven by a massive democratization in mortgage credit and the growth of innovations in securitized markets. Due to short term economic incentives to do so, these changes have been under-appreciated by the mortgage industry, the Nationally Recognized Statistical Rating Organizations, and investors. If the market demand for mortgage backed securities and collateralized debt obligations decline and assumptions by rating agencies are incorrect, the risks may be transmitted from the market to the real economy. " "If non-conforming MBS demand wanes significantly or if MBS performance models prove inadequate, we could witness a market driven downward cycle of model assumption problems leading to downgrades, reduced mortgage liquidity and further downward pressure on home prices. This would be especially likely in markets that have seen dramatic speculative and second home purchases. As home prices fell the new breed of speculative homebuyers would begin to list investment properties putting further downward pressure on prices. As this spiral continues we could see prepayment and default models falter again, thus reasserting this "death spiral." Unfortunately, it is unlikely Congress will act until after a crisis of some uncertain magnitude has presented itself. The risk of spillover into the economy Perhaps investors will not get spooked or become markedly credit risk averse and we will get that hoped for soft-landing as regional economic activity suggests. However, if history can be used as a guide it would force consideration that excess liquidity in financial markets tends to dry up abruptly. Given the size of these markets a reversal in liquidity, due to endogenous or exogenous factors, could result in significant impact on the real economy. Several investment banks bottom lines would be hurt as securitization volumes decline; Private mortgage insurers capital would be stressed; Many banks would have to increase reserves and take write downs; Originators would have to consider implicit recourse risks; Investors in unrated tranches would get badly hurt and; Investors in some investment grade trancheswould see loss rates that weren't in NRSRO models. All of this could spill into the real economy and remove the new bidder at the same time that inventories are piling up. It is not certain of course that a hard landing scenario will occur since the market trigger would, by definition be a surprise, but it appears irresponsible for risk managers to merely "buy the rating" without greater scrutiny of the assets they are purchasing or of the rating agencies work. This is not your father's housing cycle; it is a liquidity cycle driven by a rapid expansion and democratization of credit. Viewed through this lens, one is reminded that housing cycles usually unwind slowly but massive credit growth cycles usually implode. "")

66. *See Non-Monetary Effects, supra* note 39, at 257 ("The basic premise is that, because markets for financial claims are incomplete, intermediation between some classes of borrowers and lenders requires nontrivial market-making and information gathering services. The disruptions of 1930-33 (as I shall try to show) reduced the effectiveness of the financial sector as a whole in performing these services. As the real costs of intermediation increased, some borrowers (especially households, farmers, and small firms) found credit to be expensive and difficult to obtain. The effects of this credit squeeze on aggregate demand helped convert the severe but not unprecedented downturn of 1929-30 into a protracted depression.").

Rather than respond to the reality of the crisis with decisive action, senior Administration Officials spent the period from late 2005 to 2008 doing very little beyond offering expressions of confidence.[67] Even glaring market signals such as significant increases the spreads on commercial paper failed to dissuade them of their view "this is a crisis of confidence" and "the problem is contained to subprime."[68]

It was only with the failure of Bear Stearns in March 2008 that we saw significant steps taken to stabilize the situation. Even then, however, intervention was largely focused on preventing the collapse regulated financial institutions rather than on addressing the ongoing backdrop of asset price deflation. The Fed began to set up facilities to address the risk of runs on non-regulated primary Wall Street dealers, players who – as risks during this cycle were transferred from the backs of traditional depository institutions to capital markets players – had taken on so many of the tasks of financial intermediation. Even in these areas their understanding of the seriousness of the risks was lacking. Although they set up a primary dealer facility in March 2008 and placed New York Fed and SEC staff at Lehman Brothers (where they remained for the next 6 months), Lehman failed in September 2008 without anyone questioning what regulators at the New York Fed had been doing during the prior months.

Despite these early efforts, the crisis deepened: Countrywide, IndyMac, Fannie Mae and Freddie Mac, Lehman, Merrill, the commercial paper markets, AIG, Washington Mutual, Goldman Sachs, Morgan Stanley, … finally, just as Treasury Secretary Mellon had gone to Congress for the authority to stabilize the financial system through the Reconstruction Finance Corporation, Secretary Paulson went to Congress with a plan to make solvent the insolvent with government dollars. Just as the SEC banned short sales in 1932 (largely at the request of the weakest financial payers) the SEC banned short sales in September.

Just as the RFC plowed money into banks and the banks responded by hoarding, fully aware that as the asset values of their holdings degraded they would require the newfound capital for regulatory capital purposes, the banks that have received monies from TARP

---

67. *See, e.g. Treasury Secretary Expresses Confidence in Economy, Says China Is Not an Economic Enemy*, THE AMERICA'S INTELLIGENCE WIRE, Mar. 4, 2007 ("Treasury Secretary Henry Paulson says the economy is healthy, inflation seems under control and the U.S. should not perceive China as an economic enemy. After a week in which the Dow Jones industrials posted their worst weekly performance in more than four years, Paulson said in a television interview broadcast Sunday he felt good about the economy and discounted the chance of an economic downtown."). *See also Paulson Expects Economic Growth to Continue*, REUTERS, Sept. 14, 2007 ("Treasury Secretary Henry Paulson said on Friday that it will take time to work through the problems contributing to current financial market turmoil but expressed confidence U.S. growth will not be derailed.…"I feel very confident that this economy is going to continue to grow," Paulson said in an interview with CNBC television. "Inflation is contained and that is obviously the key to extending an economic expansion."…"The real economy is very healthy in this country, very strong outside of this country and with that as a backdrop it gives me great confidence we're going to be able to work our way through this.") Finally, *see* Jon Nones, *Bernanke Dripping with Confidence over U.S. Economy*, Feb. 14, 2007, ("Overall, the U.S. economy seems likely to expand at a moderate pace this year and next, with growth strengthening somewhat as the drag from housing diminishes," the Fed chief told the Senate Banking Committee. But he said, it will "be some time before we can be confident that underlying inflation is moderating as anticipated." If inflation doesn't wane as the Fed expects, policymakers are "prepared to take action," Bernanke said.").

68. Les Christie, *The housing slump: How deep is the pain?,* CNNMoney.com, Aug. 3, 2007 ("The U.S. government has downplayed the risk of the subprime meltdown spreading. Treasury Secretary Henry Paulson has said the effects are largely contained, and the economy is still strong.").

have not begun to lend but continued to hoard and occasionally speculate. Perhaps there are no solvent borrowers willing to invest as asset prices continue to fall, perhaps there are no borrowers worthy of financing, perhaps great uncertainty about the future of top tier tax rates and corporate tax rates are causing hesitation in spending. Perhaps, until we address the broken tools of financial intermediation, remove the cancerous assets through market mechanisms, ply the system with massive expansion of the monetary base and create new incentives for growth it will be impossible to broadly stabilize asset prices. The lessons of the Great Depression are of great importance not just as academic concerns but also for an understanding of the risks of economic, social, and political instability that such a crisis, if left unaddressed, could present.

Whether or not the parallels between the 1930's and the current economic environment are complete, it is clear we will see continued deleveraging stemming from the loss of asset-backed-securitization capacity; the effects of the loss of investment banks and prime broker capacity; the loss of mortgage origination capacity; the loss of commercial lending capacity; the loss of banks; and the ongoing redemptions and losses of hedge funds. The deleveraging is likely a necessary and a reasonable path to sustainable growth. However, that is not to suggest that deflation is, or must be a coincidental economic backdrop. Instead, the tools and methods exist to allow these processes to occur in an environment with offsetting coordinated monetary, fiscal and structural supports to foster economic equilibrium.