

# Mortgage Backed Securities, Wall Street, and the Making of a Global Financial Crisis

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**M**aneuvering through turbulent capital markets complete with its risk, volatility, and rewards has never been an easy task. Nevertheless, today, the level of risk and volatility is such that many of the most astute and legendary Titans of Wall Street are on the verge of extinction. With pervasive fear and financial panic gripping markets worldwide, many Americans, as well as foreign investors, wonder how our dynamic economic system could reach the brink of total collapse.

The current economic crisis involves several factors: an unwarranted multi-trillion dollar bet made by world financiers that an unproven investment theory was correct, a prolonged absence of regulatory oversight and enforcement in several over-leveraged markets, and refusals of major financial institutions to self regulate by negligently ignoring substantial warning signs in pursuit of over-sized profits.

The following article will address how a mortgage based problem grew into a worldwide financial meltdown that now presents unknown, yet certainly long-term, challenges for our legal and economic systems. The article will begin by analyzing Wall Street's evolutionary involvement in mortgage backed securities. Next, the article will discuss the drastic decline of world markets due, in large part, to key financial institutions being over-leveraged in these securities and their related derivatives. Finally, this article will conclude by offering some possible regulatory strategies and insights that will, hopefully, prevent the replay of such a financial crisis in the future.

## I. THE RESCUE

On October 3, 2008, President Bush signed into law the Emergency Economic Stabilization Act.<sup>1</sup> The Act mandates a seven hundred billion dollar rescue of distressed financial institu-

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tions and companies whose failure would have had an overwhelmingly negative impact upon our national economy and global markets.<sup>2</sup> The rescue is arguably the largest financial intervention in the history of the United States.

The new law authorizes the United States Treasury Secretary to enter these distressed financial markets by purchasing problematic assets from troubled financial institutions and injecting large sums of money into failing businesses in key industries.<sup>3</sup> A significant percentage of the impaired assets are backed by home mortgages that have been losing value and foreclosing at an alarming rate. These assets are commonly known as mortgage backed securities.

## II. A HOUSE IS NOT JUST A HOME

For years, the wizards of finance have viewed the steady rate of appreciation within the United States housing market with envy. The problem for many investors though was that the residential real estate market in the United States was quite limited to investors interested in building, buying, or selling homes.

Real estate financing was conducted on Main Street, not on Wall Street. Local banks would underwrite loans holding individual notes until a default occurred or until the maturity of the mortgage was paid off or refinanced.<sup>4</sup>

Based on the highly regarded housing markets in the United States, Wall Street was always interested in employing mortgages as an investment tool. Nonetheless, it was universally thought to be an unworkable concept because of the credit risk associated with mortgages in terms of the unpredictability of prepayments,

refinancing, and defaults. Thus, without a predictable way to trade mortgages, and without a way to determine credit risk associated with them, the United States housing market, and all its great value, was traditionally by-passed by Wall Street and international investors.

### III. BUILDING A BETTER MOUSE TRAP

This would all change, however, in the 1970's when an innovative Salomon Brothers bond trader, Lou Ranieri,<sup>5</sup> devised a solution to the investment dilemma associated with home mortgages. He created the investment vehicle called mortgage backed securities.<sup>6</sup> Under this new innovative model, mortgages would be characterized and pooled into bond type securities that could be traded on Wall Street and world markets. The process of pooling these mortgages together is called securitization.<sup>7</sup>

During securitization, the pooled mortgages are usually transferred to a financial institution that then creates a new and separate legal entity, such as a trust or special purpose vehicle. The new legal entity then issues securities made up of these pooled mortgages that can be purchased and traded on the secondary market. The new securities are commonly known as tranches.<sup>8</sup>

Tranches can best be defined as separate and distinct portions of the original mortgage notes that are coupled together with different interest rates.<sup>9</sup> Tranches are usually ranked in order of priority based on different subordinate classes. Typically the subordinate classes have different cash flows and payment schedules associated with them. Such a system of subordination acts to shift the risk of non-payment to the more junior classes, allowing investors to acquire securities that best suited their tolerance for risk and reward.<sup>10</sup>

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Even though mortgage backed securities generated large sums of money from their inception, it was really not until the more traditional sources for mortgage lending dried up—during the Savings and Loan Crisis of the 1980's—that Main Street started to adopt them whole-heartedly.<sup>11</sup> This new exciting financing tool opened up the United States real estate market to non-traditional real estate investors, dramatically altering investments in the United States housing market, and, unwittingly, becoming the basis for today's world financial crisis.

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### IV. THE SAFEST GAME IN TOWN

As mortgage backed securities performed outstandingly and generated profits, Wall Street, and almost every other international player, became euphoric about these new debt instruments. Believing them to be reliable and safe investments, an array of world renowned financial institutions flocked to invest.

Many foreign markets copied the United States model by creating similar debt instruments based on their housing markets.<sup>12</sup> Therefore, as the mortgage backed securities industry continued to evolve domestically and internationally, any trepidation regarding their creditworthiness was unequivocally rejected by capital markets.

The major credit rating agencies—Standards & Poor, Fitch, and Moody's—all provided ratings to different classes of mortgage backed securities depending upon the perceived risk associated with each of the bonds.<sup>13</sup> These ratings ranged from a highly valued AAA to the lowest unrated classification.<sup>14</sup>

Each of the major credit rating agencies gave their stamp of approval for these transactions. Such an endorsement was significant because, generally, investors in capital markets relied heavily upon these credit evaluations to determine investment risk.

Additionally, these credit rating agencies were essential to the financing process because they allowed investors to dispense with an in-depth review of the underlying investment property that a primary lender would normally undertake.<sup>15</sup> Rather, the rating agencies determined the likelihood for timely repayment of the loans based on factors such as the collateral involved, statistical probability of default, and severity of potential loss.<sup>16</sup>

Certainly, a prime reason so many institutional investors were inclined to invest was because the higher rated mortgage backed securities were considered to be as safe as U.S. Treasury bonds, while the lower rated bonds were commonly given a much higher rate of return on their interest rate payments to offset any heightened risk exposure.<sup>17</sup> Unfortunately, these same credit rating agencies were later criticized for blatant conflicts of interest, because they were often funded, by some of the same institutions that were issuing these very profitable mortgage backed securities.

Echoing the coveted endorsement from the credit rating agencies,<sup>18</sup> mortgage backed securities were further believed to be reliable based on the guarantee of credit default swaps. Credit

default swaps are derivative contracts<sup>19</sup> that function as the equivalent of financial insurance for mortgage backed securities but without the same legal restrictions that are imposed on actual insurance.<sup>20</sup>

One of the unique aspects of credit default swaps was that you could purchase them without actually having to purchase the underlying mortgage backed securities that they were insuring<sup>21</sup>. Accordingly, if the mortgage backed security failed, the holder of the derivative contract could demand payment of the security even though the contract holder never experienced a financial loss themselves.

This very loop hole was later exploited by market speculators who bet against the repayment of the mortgage backed securities. Such speculations helped to push down stock prices of companies heavily leveraged in these mortgage backed securities to the ultimate detriment of world markets.<sup>22</sup> The practice became such a problem that the United States Treasury had to temporarily suspend and restrict short-term selling within capital markets to prevent the spiraling decline of world stock markets based, in large part, on the implementation of this strategy.

Furthermore, because so many Wall Street financial institutions, investment banks, and insurance companies became over-leveraged with these investment products,<sup>23</sup> some commentators have asserted that the exposure associated with these credit default swaps runs into the multi-trillion dollar range. No one knows for sure, however, because of the lack of transparency in this important shadow market.

In sum, the misguided confidence in these debt instruments was based on a number of factors.<sup>24</sup> First, the mortgage backed securities were designed with supposedly foolproof mathematical equations that claimed to eliminate, or greatly mitigate, the risk of loss associated with the transactions. Second, the underlying assets of the housing market in the United States were considered to be the best and most stable in the world. Third, the major bond and credit rating agencies had given their blessing to these transactions. Fourth, insurance type derivatives, called credit default swaps, guaranteed re-payment of these mortgages in case of default. Finally, the reliability of these transactions was generally believed to be guaranteed, or at least backed by, the quasi-governmental entities of Fannie Mae and Freddie Mac.

## V. GAIN WITH NO PAIN

Former Federal Reserve Chairman Alan Greenspan lowered interest rates<sup>25</sup> to prevent inflation, and he again lowered interest rates to increase spending after the 911 attacks. All of these sensible and necessary actions inadvertently stimulated the housing market, which ultimately increased the value of homes and the demand for mortgage backed securities.

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cial model, instead of holding individual notes until they reached maturity, local banks would sell the notes to entities such as Fannie Mae or Freddie Mac.<sup>26</sup> In return, Fannie Mae and Freddie Mac would pay the local banks off, providing them with new liquidity that enabled them to make more home loans. Fannie Mae and Freddie Mac would then securitize the loans into mortgage backed securities.

As success from these mortgage backed securities engendered more economic success, these products, and their accompanying derivatives swaps, became increasingly complex and much riskier. Meanwhile, there was no oversight to speak of, only the desire for ever increasing profits.<sup>27</sup> These investment excesses continued and became more outlandish until one day the wheels just fell off.

## VI. THE POLICE DO NOT PATROL HERE

Mortgage backed securities, credit default swaps, and other similar financial products were all functioning within an environment with a minimal amount of regulatory oversight. Contributing to this crisis was the simultaneous merging together of three primary aspects of deregulation: deregulation of capital and international markets, deregulation of the participants within these financial markets, and deregulation of the investment products sold within these markets.

Embracing the free market philosophy that markets could, and would; self-regulate the rest of the world followed the lead of the United States and deregulated their capital markets. America's financial model of deregulation had become the world's model.

Such an approach reached its apex when Congress passed the Gramm-Leach-Bliley Act of 1999. The legislation repealed the depression era Glass-Steagall Act,<sup>28</sup> which previously separated and restricted the activities of commercial banks, investment banks, and insurance companies.<sup>29</sup> Prior to the repeal of this pivotal depression era law, each entity was given its own sand box and was not allowed to play in another's sand box.

After the passage of the Gramm-Leach-Bliley Act of 1999 everyone could play in everyone else's box. This was a significant development; because, although the restrictions were lifted regarding their different spheres of financial activities and influence, these financial institutions still had significantly different roles and structural functions.

Moreover, each industry had very different business models. Commercial banks were highly regulated with strict cash

reserves requirements and FDIC guarantees attached. Investment banks had much less stringent requirements for cash reserves but offered higher economic rewards with increased risk. Insurance companies had their own unique regulatory standards altogether. Thus, all of these different parts of the financial sector sold and traded mortgage backed securities but with varying degrees of protection for investors and, ultimately, for consumers.

## VII. THE SMART GUYS NEVER LOSE

The deregulation model has had a profound impact on investors and how they are fairing during this unprecedented financial crisis. Institutional investors, such as commercial banks, investment banks, and hedge funds, were all considered sophisticated investors who understood the risk involved with mortgage backed securities. These entities were supposed to have both the financial literacy and capacity to manage the risk associated with these deregulated markets.

For many of these sophisticated investors, the attractiveness of the mortgage backed securities, and its related derivatives, were that they all operated in deregulated markets. Thus, the market participants could make large sums of money without worrying about intrusive government oversight or interference.

The prevailing thought was that sophisticated and institutional investors were so knowledgeable about investing that they could handle themselves within deregulated and highly volatile markets. This theory was based on the following assumptions. First, that sophisticated investors do not need regulatory protection because they understand how these new and complex investment products work, as well as the risk associated with them. Second, that these deregulated markets work in isolation and do not affect other markets where unsophisticated investors normally participate. Third, the theory assumed, incorrectly, that the technological interconnectivity of the global markets, and the built in safeguards of these new innovative investment products, made capital markets stronger and less susceptible to failure.

As early as the 1990's there were top regulators in the United States, such as Brooksley Born, former Chairperson of the Commodity Future Trade Commission, who were not convinced that markets would effectively self-regulate. Instead, regulators like Ms. Born sounded the alarm against capital markets over-indulgence in these deregulated transactions.<sup>30</sup> Chairperson Born emphasized that there was a potential for economic disaster to world markets because of the sheer magnitude of our over investment in a growing plethora of unmonitored and deregulated investment products.<sup>31</sup> These products included mortgage back securities, collateral debt obligations, and derivatives such as credit default swaps.

For the most part, the economic giants of the day, such as former Chairman of the Federal Reserve Alan Greenspan, voiced strong disagreement and dismay with Ms. Born's concerns.<sup>32</sup> Despite the fact that the current economic meltdown would

later exonerate Chairperson Born<sup>33</sup> and her fellow dissenters' viewpoint—at that time—the legal and economic concerns they raised were simply ignored, dismissed, and thought to be quixotic by the leaders of the established regulatory community.

## VIII. EVERYONE JOINS THE PARTY

A by-product of the mortgage backed securities explosion was more liquidity in other markets. More capital was being directed to local banks to enable them to make other loans involving items like cars, credit cards, student loans, and business loans. As a result, the standards for qualifying for such loans became more lenient as debt related funding flooded world markets. Financial institutions' insatiable appetite for record profits increased, and access to capital became much easier, which led to increased consumer spending.

The additional flood of easy capital created several economic bubbles in multiple world markets. These bubbles were different than prior bubbles, such as the dot-com craze, because these bubbles were internationally intertwined based on technology and cross border investments. All of these bubbles were initially fueled by the unchecked feeding frenzy generated by the mortgage backed securities phenomena.

By any measure, the initial economic bubble fueled by these debt instruments started within the United States housing market,<sup>34</sup> and several different factors came together to create it. Fannie Mae and Freddie Mac were purchasing mortgages from local banks at a rapidly growing rate, giving these banks substantial amounts of additional capital to loan. A fierce competition ensued for customers and profits leading many banks to issue loans to some customers with questionable credit worthiness. The Federal Reserve also lowered interest rates to record lows, and large numbers of individuals decided to purchase a new home or refinance their old homes based upon these lower rates. Consequently, an all encompassing housing boom was created where home construction and home values appreciated to levels never imagined before.

Just as noteworthy, since local banks could now easily remove risky mortgages from their balance sheets, many of these banks did not worry about whether the loans would be repaid.<sup>35</sup> The issuance of numerous no documents loans, sub-prime loans and adjustable rate mortgages became common business practice and they were issued with no worries about government oversight or defaults.<sup>36</sup>

As financial institutions took on increasingly more debt, there simply was no governmental entity or entities supervising or overseeing the process that was placing our world markets at risk.<sup>37</sup> Rather, it was as if all the financial regulators said, who are we to stop you from generating record profits?<sup>38</sup> The mortgage backed securities industry responded by seeking huge earnings with little concern for risk. The rapid infusion of additional liquidity in world markets kept accelerating the pace and size of

additional bubbles spanning across global markets and economies.

Ultimately, commercial banks, hedge funds, investment banks, home builders, realtors, and retailers were all setting record profits. In turn, such growth forced them to hire more personnel to keep up with the demands and purchasing power generated by the housing boom and the other economic



booms that it spawned. Homeowners were also gaining wealth at record rates by selling their homes for inflated values, and these bubbles were injecting cash into world markets and creating other economic bubbles.<sup>39</sup>

One bubble led to another, fostering a chain reaction that linked global financial sectors to the world economies like never before.<sup>40</sup> These bubbles acted like falling dominos, increasing value in markets worldwide.<sup>41</sup> Similarly, because of technology, and less stringent legal barriers to cross border capital transfer, these bubbles became more integrated with world economies and world markets.<sup>42</sup>

Because the United States economic model had proven itself to be the greatest wealth creator known to man, all types of investors across the globe, from sovereign funds to pension funds, joined in on the mortgage backed securities bonanza. Certainly, it was evident, now more than ever, that what happened on Wall Street affected what happened in capital markets around the world.<sup>43</sup>

## IX. THE MUSIC STOPS PLAYING

Although there were prior warning signs, when U.S. home values began depreciating rather than appreciating, it still seemed to catch many off guard. Failures within the United States housing market, in turn, began to gravely impact what was going on in capital markets around the world. In fact, the tables turned so quickly that a reverse domino effect was engendered. Like a house of cards, the once safe and reliable mortgage backed securities began to rapidly lose value and become due. No country or global financial market whether in the developed or developing world seems to be able to insulate itself from the financial shock waves associated with this unexpected and rapid world decline of unbelievable proportions. Similarly, its companion credit default swaps did not fair any better.

The United States housing market became undependent, destabilizing the secondary markets and all the investment

products associated with it. Housing prices peaked in the United States in early 2005 and began declining in 2007.<sup>44</sup> Foreclosures then increased in the United States at record levels throughout 2006, continuing throughout 2008.<sup>45</sup> Residential home sales fell and inventory for unsold homes increased to record levels based, in large part, on inappropriate sub-prime mortgages that had been sold to individuals

who could never afford them in the first place.<sup>46</sup>

The speculative housing bubble, and the world financial products tied to them, plummeted, with homes declining by previously unheard of amounts and producing an unprecedented market correction. Some estimate that now millions upon millions of homes in the United States have negative equity.<sup>47</sup> This occurrence has, unfortunately, created a great temptation for many homeowners to just walk away from their homes, which some may perceive to be no longer economically viable.

Dubious risk taking had finally caught up with the United States housing market. Such risk had created bad and impaired real estate assets that have now sent the housing market into a steep downward spiral that no one could stop. The looming catastrophe was made that much worse because so many of the world economies were heavily invested in these impaired assets through their ownership in mortgage backed securities and credit default swaps.

In retrospect, few experts believed that the United States housing market would experience such a huge and rapid decline in value.<sup>48</sup> Thus, many major financial institutions around the world took on debt obligations from mortgage backed securities and credit default swaps far greater than their capacity to repay should their assumptions about the United States housing market ever prove to be wrong.

Investors increasingly became concerned that the collateral backing the mortgage backed securities they owned was falling instead of rising. As mortgage backed securities lost their credit-worthiness at a record pace mass hysteria spread from Wall Street to global economies all over the world. Consequently, rating agencies lowered their ratings on what some contend is a trillion dollars or more worth of mortgage backed securities.

With ballooning housing surpluses, the United States real estate market loan-to-debt ratio was out of balance,<sup>49</sup> causing financial institutions to dramatically lower the value of the mortgage backed securities they held. As if this was not enough

economic despair, many of these same institutions were then forced to turn around and borrow additional capital, because they needed to maintain a certain debt-to-capital ratio in case they had to pay off their bad debts associated with the mortgage backed securities meltdown.<sup>50</sup>

More troubling, perhaps, is that many market experts contend that the decline in housing values in the United States has not hit bottom.<sup>51</sup> Thus, an accurate evaluation of how severely impaired the mortgage back securities problem will become remains, for the most part, unknown.

In addition to the falling home values in the United States, many of the financial institutions who invested in mortgage backed securities are no longer certain of what type of risk is associated with the different mortgages included in each of these pooled investments. Frankly, these real estate assets have been divided, pooled, and sold into so many different pieces, in so many places that it becomes almost impossible for highly leveraged financial institutions to determine their potential for liability.

With that in mind, it is easier to understand why credit lending has frozen, because the very financial institutions that control the majority of the currency in the world are now reluctant to even extend credit to each other, as exhibited by the current London Interbank Offered Rate measurements.<sup>52</sup> Banks are simply unsure of the extent of their own debt exposure in the ongoing crisis. These institutions fear the potential for insolvency if their own debts come due and they do not have enough money on hand.<sup>53</sup> Thus, the world financial system has entered into a bunker mentality where everyone distrusts the other's viability and potential longevity.<sup>54</sup> Of course, if banks are unwilling to lend to each other, businesses and consumers certainly cannot obtain credit from these institutions, no matter how outstanding their credit record.

## **X. WE HAVE AN EMERGENCY**

Federal Reserve Chairman Ben Bernanke, a student of the great depression,<sup>55</sup> saw early indicators of the economic tsunami to come. Consequently, he, and Treasury Secretary Henry M. Paulson, Jr., took a number of actions to attempt to prevent the coming together of this perfect financial storm.

Chairman Bernanke opened the commercial banks discount counter to investment banks to increase their liquidity. Chairman Bernanke and Treasury Secretary Paulson working as a team had the Federal Reserve take the unprecedented actions of guaranteeing the impaired mortgage backed securities debt of Bears Stearns as a requirement for J.P. Morgan Chase to acquire the failing investment bank.<sup>56</sup> The men then jointly orchestrated the unprecedented federal takeover of Fannie Mae & Freddie Mac, the two primary issuers of mortgage backed securities on the secondary market.<sup>57</sup> Treasury Secretary Paulson then led the way for the federal government to pump billions and billions of

dollars into the insurance giant American International Group (AIG) to keep it from going under due to its over exposure with credit default swaps.<sup>58</sup> Finally, although the United States government has not yet acted, it is likely that these two financial leaders or the government officials to succeed them will work together with Congress to provide homeowners with some direct financial assistance to prevent the ever-increasing rate of foreclosures in the housing market,<sup>59</sup> as well as provide other essential industries with some type of economic relief, such as the auto industry.

Even after all these extraordinary actions were taken, both Chairman Bernanke and Secretary Paulson realized that it still was not enough, and that the United States, and other world markets, were still at risk of a total shut down and that the ongoing piecemeal approach would not be sufficient. Thus, with the approval of the White House, they went to Congress to ask for immediate help for our economic system in the form of a seven hundred billion dollar emergency bailout.<sup>60</sup>

Under much political pressure, and with some bumps along the way, Congressional leaders in both parties marshaled up enough votes to pass the emergency economic rescue legislation in record time. The passage of this law, however, was not enough to stop the volatile domestic and international stock markets from going into violent convulsions.

Accordingly, stock markets all over the world lost market capitalization at record rates. Illustrative of this point, during the same time period, "the United States S&P fell by \$384.4 billion; Japan's Nikkei 225 lost \$105.9 billion; Russia's Micex lost \$94.7 billion; China Hang Seng lost \$67.7 billion; Britain FTSE 100 lost \$56.4 billion; Saudi Arabia's Tadawaul All Share lost \$37.8 billion; South Africa's FTSE/JSE TOP 40 lost \$28.3 billion; South Korea KOSPI's lost \$24 billion; Brazil Bovespa's lost \$23.8 billion; and India Sensex lost \$21.6 billion."<sup>61</sup>

Meanwhile, the heads of state and finance ministers from all around the world have joined together to tackle this global problem. Together they are working on measures to prevent, at best, a global recession and, at worst, a global pandemic.<sup>62</sup> Many countries have taken the extraordinary step of taking equity positions within their national banks and other critical financial institutions in an attempt to stop the global hemorrhaging.<sup>63</sup> The United States has also adopted this unprecedented move.<sup>64</sup> Many critics have argued, though, that these actions, guised as a financial rescue, are in fact blatant socialism.<sup>65</sup>

Today we are experiencing stagnation in sales of stocks, bonds, and real estate. We are also experiencing a decline in aggregate consumer spending. The Federal Reserve recently reported in its Beige Book how our economy has significantly slowed down in every major industry and financial sector.<sup>66</sup> Similarly, state and local economies are adversely affected by this economic slow down. These governments have been forced to deeply cut budgets across the board,<sup>67</sup> while the unemployment rate has risen to the highest it has been in over a decade.<sup>68</sup>

Additionally, this crisis has had real and severe consequences within the financial sector. Every major investment bank, some who had been around for more than a hundred years, now no longer exist as stand alone companies. Hedge funds are also failing at a record rate around the world. Finally, many major banks are being forced to close their doors or merge with former competitors.

But, even after these emergency economic measures bear fruit, the much more difficult job of determining long-term legal and economic strategies will begin. Our policymakers must determine which portions of our dysfunctional and mercurial capital markets work and which portions need to be reformed.

Not surprisingly, because financial institutions handle other people's money, the conduct of these institutions must instill trust through transparency. Many of the underlying concepts that support sophisticated investors and deregulation must certainly be reworked. Thus, the current ubiquitous shadow markets must be limited in scope or eliminated altogether.

Most importantly, under the current financial scenario neither raising taxes or indiscriminately printing money seems to be a viable option. Ironically the government will probably be forced to borrow substantial sums of money to pay for most of its financial rescue efforts. For this reason, it is critical for our leaders to be very prudent about how they spend taxpayers' money in this crisis, especially since it is highly likely that multiple bailouts will be required. Certainly, we do not want to make a terrible matter worse by unintentionally putting the financial viability of our own nation at risk based upon taking too heavy a stake in deflated assets and failing companies. Therefore, both policymakers and citizens alike must be vigilant in watching for unintended consequences of any new policies.

## **XI. TO GO WHERE NO ONE HAS GONE BEFORE**

With that cautionary warning, now is still undoubtedly the time for new ideas and transformative solutions. The current financial crisis shows that many of the assumptions about deregulation were based upon a flawed model. Former Federal Reserve Chairman Greenspan emphasized this very point before Congress when he stated that, to his surprise and shock, the deregulated market model has proven to be flawed.<sup>69</sup>

Our political and business leaders must work together to revamp our currently ineffective and outdated regulatory system. President Bush acknowledged this during his recent press conference when he stated: "Once this crisis is resolved, there will be time to update our financial regulatory structures. Our 21st century global economy remains regulated by outdated 20th century laws."<sup>70</sup>

To protect capital markets worldwide a new regulatory scheme must be implemented that applies a balancing test of regulatory options. We can no longer embrace the false choices of deregulation versus regulation. Instead, we must institute smart

regulations that protect global markets, investors, and consumers, while not stifling the profitability of businesses across the globe.

Regulators will have a variety of potential paths to pursue. Such regulatory reorganization can call for new laws and new powers for the Federal Reserve, the Securities and Exchange Commission, the Office of the Comptroller of the Currency, and/or the Office of Thrift Supervision. Similarly, a merger between the Securities and Exchange Commission and the Commodity Futures Trade Commission or the creation of a totally new regulatory agency with its own special goals and objectives are all possibilities.

This author contends that whatever new regulatory structure is chosen, at a minimum, it must incorporate the following within its mission and purpose. The agency or agencies must have an international scope and understanding of integrated markets and how they work in conjunction with world economies. The agency or agencies must be able to regulate formerly deregulated markets and products. The agency or agencies must implement significant capitalization requirements for all the major financial institutions and entities that are operating within global markets. Ultimately, the agency or agencies must be technologically advanced and able to understand, oversee, and manage the complex computer systems that are now at the epicenter of all financial transactions today.

## **XII. CONCLUSION**

In reality, there is probably not a silver bullet for this economic crisis but, rather, a series of steps that must be undertaken then revisited and refined. While the regulatory and economic challenges ahead are formidable, there are many lessons to be learned from the ongoing financial crisis. First, there is no such thing as a risk-free investment. Second, markets do not self-regulate, and, if they do, the corrections they engender may be too severe a price for our economic systems to pay. Third, while sophisticated and institutional investors may be knowledgeable and aware of many of the risks involved in innovative and exotic investments, they still can make collectively poor decisions that threaten our economic system and, ultimately, impact investors and consumers worldwide. Finally, regulators must actively protect the world's financial system from the over-exuberance of investors in a seemingly profitable but unproven investment vehicle such as mortgage backed securities.

As a final note, although there will be much economic pain throughout this process, we should learn from these painful lessons and use this as an opportunity to build a stronger and more efficient world economic system. If we just solve the short-term problem without learning the important lessons from it, we may unfortunately experience again the same types of problems in the future with similar or more disastrous results. **BLB**

## ENDNOTES: *Randolph C. Thompson*

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<sup>1</sup> Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343 (2008) (providing "authority for the Federal Government to purchase and insure certain types of troubled assets for the purposes of providing stability to and preventing disruption in the economy . . .").

<sup>2</sup> *Id.* § 113(a)(1) and 115(a)(3).

<sup>3</sup> *Id.*

<sup>4</sup> Kathleen C. Engel & Patricia A. McCoy, *Turning A Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039, 2049 (2007).

<sup>5</sup> See generally, MICHAEL LEWIS, *LIAR'S POKER* (Viking Penguin 1990).

<sup>6</sup> *Id.*

<sup>7</sup> See, e.g., Georgette C. Poindexter, *Subordinated Rolling Equity: Analyzing Real Estate Loan Default in the Era of Securitization*, 50 EMORY L.J. 519, 522-23 (2001).

<sup>8</sup> See, e.g., Engel & McCoy, *supra* note 4, at 2046.

<sup>9</sup> *Id.*

<sup>10</sup> *Id.* at 2047.

<sup>11</sup> See Stephen Finn, *Real Estate Industry Turns to Wall Street: Banks are Skittish, But Developers Need Capital*, LEGAL TIMES, Nov. 9, 1992, at S-31.

<sup>12</sup> See generally Pelma Jacinth Rajapakse, *Issuance of Residential Mortgaged Backed Securities in Australia – Legal and Regulatory Aspects*, 29 U. OF NEW S. WALES L.J. 173 (2006) (describing residential mortgaged backed securities (RMBSs) in Australia).

<sup>13</sup> See, e.g., Poindexter, *supra* note 7, at 543.

<sup>14</sup> Engel & McCoy, *supra* note 4, at 2054.

<sup>15</sup> *Id.* at 2060-61.

<sup>16</sup> See Poindexter, *supra* note 7, at 544.

<sup>17</sup> See Engel & McCoy, *supra* note 4, at 2054.

<sup>18</sup> See Joseph Philip Forte, *A Capital Markets Mortgage: A Ratable Model for Main Street and Wall Street*, 31 REAL PROP. PROB. & TR. J. 489, 492-93 (1996).

<sup>19</sup> See Engel & McCoy, *supra* note 4, at 2063.

<sup>20</sup> See Matthew Phillips, *The Monster That Ate Wall Street*, NEWSWEEK, Oct. 6, 2008, at 46-47.

<sup>21</sup> See Engel & McCoy, *supra* note 4, at 2063.

<sup>22</sup> See generally Thomas Lee Hazen, *Public Policy: Rational Investments, Speculation or Gambling? Derivatives Securities and Financial Futures and Their Effect on the Underlying Capital Markets*, 86 NW. U. L. REV. 987 (1992) (describing, generally, the role speculation has in the derivative securities market).

<sup>23</sup> See Phillips, *supra* note 19, at 46-47.

<sup>24</sup> See generally KENNETH G. LORE & CAMERON L. COWAN, *MORTGAGE-BACKED SECURITIES DEVELOPMENTS AND TRENDS IN THE SECONDARY MORTGAGE MARKET* (West Publishing Group 1991).

<sup>25</sup> See Phillips, *supra* note 19, at 47.

<sup>26</sup> See WILLIAM BARTLETT, *MORTGAGE-BACKED SECURITIES: PRODUCTS, ANALYSIS, TRADING 3* (Prentice Hall 1989).

<sup>27</sup> Engel & McCoy, *supra* note 4, at 2075.

<sup>28</sup> Gramm-Bliley Act of 1999, Pub. L. No. 106-102, § 101(a), 113 Stat. 1338, 1341 (1999).

<sup>29</sup> Glass-Steagall Act of 1933, 12 U.S.C. § 377 (1994) (repealed 1999).

<sup>30</sup> See Peter S. Goodman, *The Reckoning: Taking Hard New Look at a Greenspan Legacy*, N.Y. TIMES, Oct. 9, 2008 at A1.

<sup>31</sup> *Id.*

<sup>32</sup> *Id.*

<sup>33</sup> *Id.*

<sup>34</sup> See, e.g., Christopher Farrell, *How Wall Street is Driving the Mortgage Market*, BUS. WK., May 4, 1987, at 108.

<sup>35</sup> Engel & McCoy, *supra* note 4, at 2067.

<sup>36</sup> *Id.* at 2069.

<sup>37</sup> See Goodman, *supra* note 27.

<sup>38</sup> See Jacob Weisberg, *Name That Economy*, NEWSWEEK, Oct. 13, 2008, at 34.

<sup>39</sup> See Steven Pearlstein, *With Bubbles Popping Worldwide, No Wonder the Economy's Gone Flat*, WASH. POST, Oct. 7, 2008, at D1, D4.

<sup>40</sup> *Id.*

<sup>41</sup> *Id.*

<sup>42</sup> *Id.*

<sup>43</sup> Heather Landy, *U.S. Shares Sink Despite Late Rally*, WASH. POST, Oct. 7, 2008 at D1, D3.

<sup>44</sup> Niall Ferguson, *The End of Prosperity?*, TIME MAGAZINE, Oct. 13, 2008, at 36-39; *Rate of Home Foreclosures Hits Record*, N.Y. TIMES, C4 Sept. 7, 2007

<sup>45</sup> Reuters, *Rate of Home Foreclosures Hits Record*, N.Y. TIMES, Sept. 7, 2007, at C4.

<sup>46</sup> *Id.*

<sup>47</sup> Karen Blumenthal, *'Underwater' Need Not Mean Foreclosure: Why Most People Who Owe More Than A Property's Worth Will Still Keep Their Homes*, WALL ST. J., Nov. 5, 2008, at D1-D2.

<sup>48</sup> See Patrice Hill, *Congress Rips Greenspan for Crisis: Ex-Fed Chief Concedes to Flawed Faith in Markets*, THE WASH. TIMES, Oct. 24, 2008, at A1, A10.

<sup>49</sup> Ferguson, *supra* note 46, at 38.

<sup>50</sup> *Id.*

<sup>51</sup> See *id.* at 36-39.

<sup>52</sup> See Steven Mufson & Neil Irwin, *Dow Closes Below 10,000 Despite Late Rally*, WASH. POST, Oct. 7, 2008, at A11.

<sup>53</sup> See Andrew Ross Sorkin, *One Day Doesn't Make A Trend*, N.Y. TIMES, Oct. 21, 2008, at B1, B12.

<sup>54</sup> *Id.* at B12.

<sup>55</sup> See Ferguson, *supra* note 46, at 39.

<sup>56</sup> *Id.*

<sup>57</sup> *Id.*

<sup>58</sup> *Id.*

<sup>59</sup> See Peter Whoriskey & Zachary A. Goldfarb, *Treasury Considers Backing Mortgages: FDIC Aims to Help Homeowners*, WASH. POST, Oct. 24, 2008, at A1, A10.

<sup>60</sup> *Id.*

<sup>61</sup> Kevin Sullivan & Edward Cody, *World's Stock Markets Plunge: Investors Fear Moves By U.S., Europeans May Not Be Enough*, WASH. POST, Oct. 7, 2008, at D1.

<sup>62</sup> Michele Kelemen, *Eight Isn't Enough: G-20 Countries to Meet in D.C.*, NPR MORNING EDITION, Nov. 12, 2008.

<sup>63</sup> See David Cho & Binyamin Applebaum, *Tipping Point?: Unfolding Worldwide Turmoil Could Reverse Years of Prosperity*, WASH. POST, Oct. 7, 2008, at A1, A10.

<sup>64</sup> See Deborah Solomon & David Enrich, *Devil is in the Bailout Details*, WALL ST. J., Oct. 15, 2008.

<sup>65</sup> Jacob Weisberg, *NAME THAT ECONOMY*, NEWSWEEK, Oct. 13, 2008, at 34.

<sup>66</sup> See generally FEDERAL RESERVE, *BEIGE BOOK: SUMMARY OF COMMENTARY ON CURRENT ECONOMIC CONDITIONS BY FEDERAL RESERVE DISTRICT* (April 2008), <http://www.federalreserve.gov/FOMC/BEIGEBOOK/2008/20080416/fullreport20080416.pdf>.

<sup>67</sup> See Andrew Taylor, *Governors, Mayors Ask Washington for Fiscal Help*, ASSOCIATED PRESS, Oct. 30, 2008.

<sup>68</sup> Peter S. Goodman, *Jobless Rate at 14-Year High After October Losses*, N.Y. TIMES, Nov. 8, 2008.

<sup>69</sup> Neil Irwin & Amit R. Paley, *Greenspan Says He Was Wrong on Regulation: Lawmakers Blast Former Fed Chairman*, WASH. POST, Oct. 24, 2008, at A1, A10.

<sup>70</sup> *President Bush's Address to the Nation on Financial Crisis*, FIN. WK., Sept. 25, 2008.