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## Blowing Bubbles: Participations, Derivatives, and How Sharing Risk Creates Banking Crises

Jared M. Burden

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## COMMENT

### **BLOWING BUBBLES: PARTICIPATIONS, DERIVATIVES, AND HOW SHARING RISK CREATES BANKING CRISES\***

I. INTRODUCTION .....	551
II. PARTICIPATIONS AND THEIR USES.....	554
III. PENN SQUARE BANK: BOOM AND BUST .....	555
IV. PARALLELS TO TODAY: CAUSES OF THE CURRENT CRISIS.....	562
A. Public Policy .....	562
B. Fiscal Policy.....	563
C. Subprime Mortgages .....	564
D. Derivatives .....	564
V. CONNECTING THE DOTS: PARTICIPATIONS AND DERIVATIVES .....	566
VI. REGULATING RISK SHARING .....	569
VII. REGULATING RECEIVERSHIPS.....	571
VIII. CONCLUSION .....	574

#### I. INTRODUCTION

The warning bells have been ringing for some time,<sup>1</sup> but only recently has the United States begun to realize the enormity of the financial crisis that has enveloped its economy.<sup>2</sup> The situation, according to critics, has its genesis in the early and middle

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\* This comment was written during the fall of 2008 at the height of the economic crisis. Since that time there have been too many developments to catalogue, including the introduction to Congress of several reform bills with various provisions that are intended to ensure that such a catastrophe never happens again. To the extent that these bills incorporate any of the suggestions made herein, it is coincidental. Moreover, please forgive any outdated phrases, arcane descriptions, or even facts that lack the clarity and currency that might be expected were this piece composed closer to the time of this issue's publication.

1. Larry Elliott et al., *U.S. Bank Crisis Sparks Panic in Markets*, <http://www.guardian.co.uk/business/2008/mar/18/useconomy.marketturmoil> (Mar. 18, 2008).

2. Edmund L. Andrews & Graham Bowley, *Dow Rises 370 Points as U.S. Plans Financial Rescue*

parts of the 2000s when rises in housing prices were fueled by low interest rates, creating an enormous housing bubble in the process.<sup>3</sup> This investor-friendly environment fostered rampant speculation by banks and other lenders and led to an explosion in high risk, subprime mortgage loans.<sup>4</sup> When the bubble finally burst, “borrowers started to default on mortgages. As defaults piled up, the complex securities Wall Street had created from those mortgages began to crumble.”<sup>5</sup> In March of 2008, the crisis began affecting major financial institutions and resulted in an unexpected, international credit crunch.<sup>6</sup> The first victim of the crisis was the giant investment bank Bear Stearns.<sup>7</sup> Subsequently, numerous banks, mortgage lenders, and insurance companies have collapsed.<sup>8</sup> Some institutions such as Fannie Mae, Freddie Mac, and American Insurance Group (AIG) have prompted high profile bailouts by the federal government.<sup>9</sup> Still other companies, like the aforementioned Bear Stearns, have been bought for a pittance by competing financial institutions who have so far managed to stave off the crisis.<sup>10</sup>

While the events of the last few months may seem novel because of their enormity,<sup>11</sup> it should be remembered that the United States’ economy has seen its share of economic crises, particularly those that have banking at their epicenter.<sup>12</sup> Perhaps because it stands as one of our more recent examples, the collapse of Penn Square Bank and the resulting shockwaves that the banking industry absorbed in the early 1980s makes for an interesting comparison in the very least.<sup>13</sup> There, too, an overvaluation of collateral<sup>14</sup> led to a systemic crisis on a national scale.<sup>15</sup> When the value of the collateral suddenly dropped, or rather, more euphemistically, when there was a “correction” in the market, Penn Square Bank was suddenly left holding an enormous stockpile of worthless

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*Package*, [http://www.nytimes.com/2008/09/20/business/economy/20cndleadall.html?\\_r=1&hp&oref=slogin](http://www.nytimes.com/2008/09/20/business/economy/20cndleadall.html?_r=1&hp&oref=slogin) (Sept. 19, 2008).

3. Mark Adleson & David Jacob, *The Sub-prime Problem: Causes and Lessons 2*, [http://www.securitization.net/pdf/Publications/Sub-prime\\_Problem\\_8Jan08.pdf](http://www.securitization.net/pdf/Publications/Sub-prime_Problem_8Jan08.pdf) (Jan. 8, 2008).

4. Yuliy Demyanyk & Otto Van Hemert, *Understanding the Subprime Mortgage Crisis 6*, <http://ssrn.com/abstract=1020396> (Aug. 19, 2008).

5. John Waggoner & David J. Lynch, *Red Flags in Bear Stearns’ Collapse*, [http://www.usatoday.com/money/industries/banking/2008-03-17-bear-stearns-bailout\\_N.htm](http://www.usatoday.com/money/industries/banking/2008-03-17-bear-stearns-bailout_N.htm) (Mar. 19, 2008).

6. Elliott, *supra* n. 1.

7. Waggoner & Lynch, *supra* n. 5.

8. Peter A. McKay, *Tumultuous Week Ends in a Rally*, <http://online.wsj.com/article/SB122181849785156423.html> (Sept. 19, 2008). The most prominent retail bank failure to date has been that of IndyMac. Kathy M. Kristof & Andrea Chang, *IndyMac Bank Seized by Federal Regulators*, <http://www.latimes.com/business/la-fi-indymac12-2008jul12,1,7375643.story> (July 12, 2008).

9. Tim Harford, *Bailouts Are Inevitable, Even Desirable*, <http://www.slate.com/id/2201343/> (Oct. 4, 2008). Apparently, the government has based its policy on the theory that an implosion of these crucial financial institutions would have far reaching consequences that would cost both the economy and the taxpayers more to fix in the future if they were simply allowed to go bankrupt. *Id.*

10. Waggoner & Lynch, *supra* n. 5.

11. McKay, *supra* n. 8.

12. George Sutton, *Penn Square Bank—20 Years Later: A Personal Recollection of the Causes and Effects of the Banking and Deposit Insurance Crisis of the 1980s*, 27 Okla. City U. L. Rev. 969, 969 (2002).

13. See Mark Singer, *Funny Money* (Alfred A. Knopf 1985).

14. See FDIC, *Managing the Crisis: The FDIC and the RTC Experience 528*, <http://www.fdic.gov/bank/historical/managing/history2-03.pdf> (last updated Feb. 4, 2004) (Here, the overvaluation was both a result of market forces and the unscrupulous actions of its own employees.).

15. Alvin C. Harrell, *Penn Square Bank—20 Years Later: Introduction to the Symposium*, 27 Okla. C. L. Rev. 945, 945 (2002).

loans and the federal government quickly forced it into insolvency.<sup>16</sup> Although a relatively small institution, Penn Square Bank's failure had a dramatic effect throughout the country.<sup>17</sup> Hundreds of banks and savings and loans went under in the aftermath.<sup>18</sup> Many of these institutions had substantial ties with Penn Square Bank through participation interests that they had purchased in various loans.<sup>19</sup> It was through these interests that the mistakes of one lender, Penn Square Bank, caused an enormous crisis for the entire country.<sup>20</sup>

It is this article's contention that, in light of the subprime mortgage crisis and its foundations in historically questionable lending practices (in particular those practices which involve selling different interests in loans), specific regulations need to be placed on participatory schemes in order to prevent future failures in the financial marketplace. It would admittedly be better to attack the heart of the problem, the overvaluation of collateral, and thus assure that banks always have adequate protection against a debtor's default. In capitalism, however, supply and demand set the prices and, inevitably, these two forces are fundamentally wrong in their valuations from time to time.<sup>21</sup> Therefore, banks should be left alone in their decisions on the value of specific collateral. Regulations must instead be fashioned both to diffuse the chance that an overvaluation will hurt the banking industry as a whole and, if possible, to rationally spread out risk so that it is impossible for one or even several bank failures to adversely affect the entire nation's economy. This can be accomplished by enacting specific regulations that control both the circumstances surrounding the creation of participations as well as the resolution of participatory interests that are held by failed financial institutions.

Part II of this article sketches out the fundamentals of participations and the role they play in a modern economy. Part III will examine the problems created by the Penn Square Bank's use of participations and the way the Federal Depositor Insurance Corporation (FDIC) resolved them in receivership. Part IV will then explore parallels between the insolvency of Penn Square Bank and the meltdown of the subprime mortgage industry, ultimately suggesting that these separate crises ultimately stem from the same regulatory problems and, therefore, suggest similar solutions. Sections V and VI will provide an overview of the current statutory and case law surrounding bank participations, paying particular attention to the economic status of participations and how they are dealt with in insolvency. Moreover, these sections will also suggest several regulations that, if instituted by Congress, may help prevent or at least mitigate future

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16. FDIC, *supra* n. 14, at 533.

17. See Harrell, *supra* n. 15.

18. *Id.* at 945.

19. FDIC, *supra* n. 14, at 531 (noting that some \$2.1 billion of interests were owned by other banks on notes held by Penn Square).

20. See Harrell, *supra* n. 15.

21. Sutton, *supra* n. 12, at 982 (mentioning in particular the oil and gas boom in the late 70s and early 80s and the internet boom of the late 90s). Moreover, it bears repeating that many economic models call for "perfect information" available to all interested parties in a particular industry before prices can be correctly set by supply and demand. EconomicExpert.com, *Perfect Information*, <http://www.economicexpert.com/a/Perfect:information.htm> (last accessed May 25, 2010). However valuable these models are in understanding the behavior of markets, in this author's opinion it cannot be credibly argued that "perfect knowledge" has ever existed in any industry, especially banking. Therefore, it is questionable whether there can ever be truly unassailable valuations of collateral that would survive any change in circumstances.

crises in the banking industry.

## II. PARTICIPATIONS AND THEIR USES

Participations are a vital tool in the banking industry.<sup>22</sup> Federal regulations are such that many small banks cannot finance larger loans by themselves.<sup>23</sup> This is due primarily to lending limits that are tied directly to an institution's capital.<sup>24</sup> Rather than send these loans to a larger bank not realize any profits from such a transaction, a smaller bank will approach other banks and financial institutions and offer them "participating" interests in the loans.<sup>25</sup> For example, a bank who can only afford to loan \$500,000 to a single customer, Bank A, may enter into a participation agreement with Bank B, who likewise can only offer \$500,000, to loan a customer \$1 million total.<sup>26</sup> Bank A, as the originating institution, then becomes the "lead bank" and "services" the loan (i.e. completes the transaction with the customer, collects the payments, figures the interest, etc.).<sup>27</sup> In exchange for putting up the other half of the money, Bank B would become a "participant" and would then be entitled to the proceeds earned from the amount that it provided (i.e. a *pro rata* share of the payments made on the principal and interest).<sup>28</sup> This practice fulfills several purposes for the originating institution, such as "increasing the volume of business, diversifying its risks, and in general improving its liquidity; conversely, those institutions which 'participate' in loans see it as a way to invest profitably with a minimum of cost, effort, and risk."<sup>29</sup>

This relatively simple concept is not immune to problems or abuse.<sup>30</sup> Participations were used heavily by Penn Square Bank<sup>31</sup> and they were a crucial component in creating the credit crisis facing our financial markets today.<sup>32</sup> Many of the problems stem from participating banks' reliance on the evaluations and determinations of the lead bank.<sup>33</sup> "[I]t is realistic, particularly when there is a great disparity of size or

22. See Richard T. Nassberg, *The Lender's Handbook* 43 et seq. (ALI-ABA 1986).

23. William A. Lovett, *Banking and Financial Institutions Law* 159 (5th ed., West 2001).

24. 12 U.S.C. § 84(a) (2009). Currently a bank can loan a single customer an amount not to exceed 15 percent of its capital. *Id.*

25. *Id.* It appears that this sort of reasoning, taken to its logical and most extreme end, provided the inspiration for Penn Square Bank's operations. See Singer, *supra* n. 13, at 19–22.

26. See generally Nassberg, *supra* n. 22, at 43–46.

27. *Id.*

28. *Id.*

29. Kevin B. Fisher, *Loan Participations and Bank Failures: the Penn Square Decisions*, 44 Sw. L.J. 753, 766 (1990) (quoting Drake & Weems, *Mortgage Loan Participations: The Trustees Attack*, 52 Am. Bankr. L.J. 23, 23 (1978)).

30. See generally Singer, *supra* n. 13.

31. *Id.*

32. Cf. Christopher L. Peterson, *Subprime: Lending, Foreclosure and Race: An Introduction to the Role of Securitization in Residential Mortgage Finance*, [http://4909e99d35cada63e7f757471b7243be73e53e14.gripelements.com/pdfs/Peterson\\_Securitization\\_Primer.pdf](http://4909e99d35cada63e7f757471b7243be73e53e14.gripelements.com/pdfs/Peterson_Securitization_Primer.pdf) (Oct. 2008).

33. Cf. Nassberg, *supra* n. 22, at 43–44. It is interesting to note that, in the pre-war mortgage market, a participating bank was generally less reliant on the lead bank's assessments. Saul B. Klamman, *The Postwar Residential Mortgage Market* 196 (Princeton U. Press 1961) ("With little or no uniformity or standardization in loan contracts, shifting ownership of mortgages among investors was quite limited and expensive. It was based necessarily upon detailed estimation and appraisal of property, neighborhood, borrower, and loan terms, and confined to places where the underlying property was located and local investors familiar with economic conditions.").

sophistication between the lead and participant banks, to expect that the participants will rely more heavily upon the lead bank's analysis, decisions, and management of the transaction . . . ."<sup>34</sup> Put more poetically, with participations "[l]iquidity is paramount[, t]rust flows freely," and disaster may be just around the corner for an unwary institution.<sup>35</sup>

Problems are compounded when a participation, instead of following the simple scheme laid out above, is turned into a commodity.<sup>36</sup> In its most extreme and recent form, millions of mortgages were "packaged" together, divvied up into pieces, and offered for sale to speculators on Wall Street as "derivatives".<sup>37</sup> The fundamental idea remains the same: there is a lead bank and participating banks (or, in other words, investors) each with a specific interest in the loan.<sup>38</sup> In these more complex systems where millions or even billions of dollars are changing hands, the utility of participations are quickly dwarfed by the potential problems they create.<sup>39</sup> The reason is simple: if a bank makes a bad loan to a home or business owner who then defaults, that bank may become insolvent.<sup>40</sup> If a separate bank owns a participatory interest in the defaulting loan, then it, too, will suffer adverse consequence. If enough loans go into default for enough banks, however, the entire system may collapse from the tangled web of dependency and liability created by such participatory schemes.<sup>41</sup> This, in essence, is the story of Penn Square Bank.

### III. PENN SQUARE BANK: BOOM AND BUST

As with seemingly all banking crises, the crisis following Penn Square Bank's collapse was a product of its time, a casualty of a cyclical market where rampant speculation led to unexpectedly large gains (at least for those involved) followed by even more precipitous losses.<sup>42</sup> The story of Penn Square Bank is tied to the oil and natural gas market of the late 1970s and early 1980s. This market was characterized by fast-rising energy prices and increased speculation.<sup>43</sup> When Jimmy Carter's Administration effectively removed price controls on newly discovered natural gas,<sup>44</sup> the price of natural gas was finally set by the market and the industry became an attractive investment for

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34. Nassberg, *supra* n. 22, at 44.

35. Singer, *supra* n. 13, at 20.

36. See Christopher L. Peterson, *Subprime Mortgage Market Turmoil: Examining the Role of Securitization—A hearing before the United States Senate Committee on Banking, Housing, and Urban Affairs Subcommittee on Securities, Insurance, and Investment*, [http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore\\_id=4f40e1b9-cc5b-4752-ba8f-0c14afc44884](http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=4f40e1b9-cc5b-4752-ba8f-0c14afc44884) (Apr. 17, 2007). Of particular interest is a confusing chart demonstrating the different interests that various actors may have in a home loan. *Id.* at 4.

37. Peter S. Goodman, *Experts See Need for Punitive Action in Bailout*, <http://www.nytimes.com/2008/09/23/business/23skeptics.html> (Sept. 22, 2008). For a more general definition of a derivative, see SEC, *Mortgage-Backed Security*, <http://www.sec.gov/answers/mortgage securities.htm> (last updated June 25, 2007).

38. Fisher, *supra* n. 29, at 767–768.

39. See generally Richard Y. Roberts & Randall W. Quinn, *Leveling the Playing Field: The Need For Investor Protection for Bank Sales of Loan Participations*, 63 *Fordham L. Rev.* 2115 (1994).

40. See generally Lovett, *supra* n. 23.

41. See Goodman, *supra* n. 37.

42. *Id.*

43. *Id.* at 977.

44. Singer, *supra* n. 13, at 79.

banks almost overnight.<sup>45</sup> Both older energy companies as well as many new players were eager to take advantage of the situation.<sup>46</sup> They were all hungry for capital to start their ventures and Penn Square Bank was eager for their business.<sup>47</sup>

The central figure in Penn Square Bank's meteoric rise and collapse was the colorfully named Beep Jennings, one time manager of the bank who, after a stint as vice president of another bank, had returned as an owner.<sup>48</sup> Jennings knew that Penn Square Bank was only a small, regional player that was cut-off from making large loans and, consequently, large profits.<sup>49</sup> Through the pre-existing concept of loan participations, however, Jennings saw an opportunity to dramatically increase Penn Square Bank's profile.<sup>50</sup> In a departure from traditional practice, Jennings's scheme called for the lead bank to become more of a middle-man, someone who facilitated the transfer of money from a large, "money center" bank to customers of the lead bank.<sup>51</sup> The idea was perfectly captured by Mark Singer:

There was such a creature as a 100-percent loan participation. In this instance the loan-originating bank had in effect ceased being a bank. It found the borrower and delivered him into the hands of the big lender, collecting a fee but not retaining any investment in the loan. For its fee, the originating bank—Penn Square, say—would "service" the loan. The bank that had bought the loan wanted tangible evidence that the borrower was worth the risk, and Penn Square had a duty to perfect any secured interest in collateral and to forward interest payments to the lender.<sup>52</sup>

Nothing about this scheme was or is now illegal.<sup>53</sup>

When the price of oil and gas went skyrocketing, Jennings went hunting for big money partners in his participation scheme.<sup>54</sup> One would think that the largest financial institutions would "avoid[ ] the temptation to dabble in areas outside their expertise."<sup>55</sup> On the contrary, lured by the promise of high energy prices, large banks such as Seattle First National Bank, Chase Manhattan, and Northern Trust Company eagerly entered into participation agreements with Penn Square Bank.<sup>56</sup> With such wealthy and powerful partners, Jennings was able to quintuple Penn Square Bank's loan portfolio within his first four years at its helm.<sup>57</sup> At the height of its success and just before its calamitous fall, Penn Square Bank had approximately \$2 billion in loans on its books.<sup>58</sup> This contrasted greatly with the slightly less than \$500 million that the bank held in

45. *Id.*

46. *Id.* at 97 et seq.

47. *Id.*

48. *Id.* at 16–17.

49. Singer, *supra* n. 13, at 19.

50. *Id.*

51. *Id.* at 19–20.

52. *Id.* at 20.

53. Board of Governors of the Federal Reserve System et. al., *Interagency Statement on the Sale of 100% Participations*, <http://www.occ.treas.gov/ftp/bulletin/97-21a.pdf> (Apr. 10, 1997).

54. Singer, *supra* n. 13, at 64.

55. Phillip L. Zweig, *Penn Square Bank: The School for Scandal*, 27 Okla. City U. L. Rev. 959, 961 (2002).

56. FDIC, *supra* n. 14, at 528.

57. Singer, *supra* n. 13, at 66.

58. FDIC, *supra* n. 14, at 527.

deposits.<sup>59</sup> If not for participations, lending on this scale would not have been possible.<sup>60</sup>

The liabilities held by Penn Square Bank, however, were literally less than half the story. Many of the larger banks who had participated in the loans, known as “upstream banks”,<sup>61</sup> held sizeable loan interests that threatened their own stability.<sup>62</sup> For example, Seattle First National held participations that were worth half of its actual equity.<sup>63</sup> Michigan National’s liabilities came closer to 150 percent of its equity.<sup>64</sup>

When considering the sheer numbers, it is not too bold to say that “Penn Square and its upstream bankers exuded arrogance.”<sup>65</sup> Many of these larger banks had bought in to Jennings’ system; they had, in essence, become a part of “a pyramid of belief”<sup>66</sup> that disregarded central tenets of banking such as “[n]ever lend people more money than they can pay back.”<sup>67</sup> Towards the end of its existence, Penn Square Bank owned only a small percentage of the loans that it carried on its books; the majority owners were the out of state, upstream banks.<sup>68</sup>

Moreover, as the quantity of loans increased, there was a systematic decrease in their quality.<sup>69</sup> The balance sheet at Penn Square Bank had never looked better,<sup>70</sup> but after an audit by the Office of the Comptroller of the Currency (OCC) in 1981, the federal government became very concerned.<sup>71</sup> The OCC “found low capital, excessive low-quality loans, inadequate liquidity, inexperienced staff, increasing problem loans, and management problems.”<sup>72</sup> This was not the OCC’s first critical report of Penn Square Bank but rather represented a snapshot of the rapidly deteriorating lending policies of Jennings and his cohorts.<sup>73</sup> After a previous inspection by the OCC, Penn Square Bank’s directors had been forced to sign an agreement to practice better lending policies; that is, the directors were tasked with creating better oversight procedures to vet their prospective borrowers and the collateral that they were offering in support of their loans.<sup>74</sup> Obviously the warning had not been heeded and, in the summer of 1982, the OCC declared Penn Square Bank a failed institution.<sup>75</sup>

When a bank such as Penn Square Bank fails, the FDIC steps in and acts as its “receiver.”<sup>76</sup> In effect, a receiver “succeeds to the rights, powers, and privileges of the institution[;]” it is not an exaggeration, then, to say that the FDIC *becomes* the failed

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59. Michael Mitchelson, *The FDIC Response to Penn Square Bank and the Local Implementation of National Policy*, 27 Okla. City U. L. 1039, 1042 (2002).

60. Cf. 12 U.S.C. § 84(a).

61. Singer, *supra* n. 13, at 20.

62. *Id.* at 154–157.

63. *Id.* at 154.

64. *Id.*

65. Zweig, *supra* n. 55, at 962.

66. Singer, *supra* n. 13, at 73.

67. *Id.* at 117.

68. Mitchelson, *supra* n. 59, at 1046.

69. Singer, *supra* n. 13, at 117.

70. *Id.* at 112.

71. *Id.*

72. FDIC, *supra* n. 14, at 528.

73. Singer, *supra* n. 13, at 112.

74. *Id.* at 73.

75. Harrell, *supra* n. 15, at 945.

76. Mitchelson, *supra* n. 59, at 1039–1040.



institution.<sup>77</sup> Invested with such power and authority, it is the receiver's duty to resolve the failed institution by collecting its assets and distributing them to the institution's depositors and creditors.<sup>78</sup> Generally, once having formed the receivership, the FDIC has three methods of dissolving the failed entity and distributing its assets: (1) it either tries to find a willing buyer who will agree to take on the liabilities of the failed institution in a "purchase and assumption;" (2) it collects the assets of the institution, liquidates them, and distributes the proceeds to the bank's depositors and creditors; or (3) it creates a "bridge" bank to completely take over the failed institution and resume operations in its place.<sup>79</sup> In pursuing one of these three courses, "[t]he FDIC is required by statute to maximize the return on the assets of the failed bank . . . and to minimize any loss to the insurance fund."<sup>80</sup> For this reason, the FDIC much prefers to merge a failed bank with another institution as this allows it to avoid paying out insured deposits.<sup>81</sup> This preference is especially true for larger institutions whose failure would both cost the FDIC more to resolve and could possibly disrupt other businesses and the broader economy on a large scale.<sup>82</sup>

Because of the uncertainties flowing from Penn Square Bank's complicated participation scheme, there was no financial institution in the United States that was willing to step in and assume the risk of purchasing the assets *and* assuming the liabilities of the failed institution.<sup>83</sup> Therefore, the FDIC was forced to structure a payout to the bank's depositors and creditors,<sup>84</sup> the most unattractive and costly solution.<sup>85</sup> As happens for every method of resolving an insolvent bank, when a payout occurs, the FDIC is required to act "in the best interests of the receivership."<sup>86</sup> To this end, the FDIC must follow a highly structured regulatory scheme that calls for certain steps to be taken to quickly, efficiently, and cheaply dispose of a failed institution.<sup>87</sup> This regulatory structure determines both how it should sell the assets and how it should pay out the claims.<sup>88</sup> First, the FDIC pays the administrative costs of the receivership.<sup>89</sup> Then, for every depository account that is equal to or less than the insured limit (\$100,000), the FDIC must pay the depositor in full.<sup>90</sup> The FDIC next turns to the institution's creditors such as (at least at the time of the Penn Square Bank receivership) those who hold a participation interest in one of the failed institution's loans.<sup>91</sup> These claims are paid out *pro rata* from whatever assets remain in the receivership estate, meaning that they

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77. FDIC, *Resolutions Handbook: Chapter 7—The FDIC's Role as a Receiver* 70, <http://www.fdic.gov/bank/historical/reshandbook/ch7recvr.pdf> (last accessed May 16, 2010).

78. *Id.*

79. Mitchelson, *supra* n. 59, at 1040–1041.

80. FDIC, *supra* n. 77, at 70.

81. FDIC, *supra* n. 14, at 529–530.

82. Lovett, *supra* n. 23, at 139–140.

83. Singer, *supra* n. 13, at 141.

84. FDIC, *supra* n. 14, at 532.

85. Lovett, *supra* n. 23, at 140.

86. Singer, *supra* n. 13, at 149.

87. FDIC, *supra* n. 77, at 72.

88. *Id.*

89. *Id.*

90. *Id.*

91. *Id.*

generally are not paid out in full.<sup>92</sup> Moreover, for those loans that go into default, the participating bank generally cannot reach the collateral to recover its investment (even assuming that the collateral would be sufficient to cover their liability).<sup>93</sup>

In examining the difficulties that the FDIC had when liquidating Penn Square Bank, it is clear that much of the trouble was caused by the FDIC's ignorance of the failed institution's specialized market.<sup>94</sup>

No one at the FDIC knew how oil-and-gas financing worked; no one acknowledged the importance of cash flow; no one understood the classic and unavoidable pyramid of the typical oil-and-gas borrower; no one seemed to care how a loss of credit would damage the value of collateral. Wherever cash or collateral could be found, the FDIC intended to be at the head of the line.<sup>95</sup>

Thus, with the FDIC's relative inexperience with the type of loans in Penn Square Bank's portfolio and its insistence on fast and often messy resolutions, it came as no surprise that the receivership of the failed institution created more problems than it solved.<sup>96</sup>

Understandably, most problems arose when the FDIC began to dispose of the elusive loans of Penn Square Bank.<sup>97</sup> The FDIC's preferred method of dealing with these loans was to sell them off, thereby granting another bank the status of lead bank and converting Penn Square Bank's interest into a liquid asset which they could then use to pay off the failed institution's creditors.<sup>98</sup> However, many difficulties attended the selling of these loans.<sup>99</sup> To begin with, many other banks held interests in these loans, thereby making it hard for the FDIC to determine how much interest there was for the receivership to sell.<sup>100</sup> Also, many possible buyers were understandably leery of taking on the loans of a failed bank.<sup>101</sup> Obviously something went wrong at Penn Square Bank and no matter how the FDIC packaged the loans, a patina of distrust would stigmatize them as either being under-performing or based on insufficient collateral.<sup>102</sup> Therefore, for many of Penn Square Bank's loans, the FDIC failed to find a buyer.<sup>103</sup> Understandably these unpurchased loans were also the most suspect loans in need of immediate attention, yet the FDIC refused to renew or reform the borrower's terms, preferring to allow the loans to slide listlessly into default.<sup>104</sup> This presented many participating banks with a troubling problem: if they held a participation in a loan that was not renewed, it could either increase their risk of loss in hopes of recovering their

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92. FDIC, *supra* n. 77, at 71.

93. *Hibernia Natl. Bank v. FDIC*, 733 F. 2d 1403, 1407 (10<sup>th</sup> Cir. 1984).

94. Singer, *supra* n. 13, at 149.

95. *Id.*

96. *See* Fisher, *supra* n. 29.

97. *Id.*

98. Charles E. Cheatham, *Economic and Regulatory Factors Relating to Penn Square Bank*, 27 Okla. City U. L. Rev. 1051, 1056–1057 (2002).

99. Singer, *supra* n. 13, at 141.

100. *Id.*

101. Cheatham, *supra* n. 98, at 1056.

102. *See id.*

103. *Id.* at 1056–1057.

104. *Id.* at 1057.

investment by buying the loan outright (which many banks, understandably, were wary of doing) or write the loss down in its books and hope that they could afford to do so.<sup>105</sup> With the projected losses of many of the upstream banks skyrocketing because of the FDIC's loan policy, lawsuits began flooding into the Western District of Oklahoma.<sup>106</sup>

Many of these lawsuits dealt with the concept of the offset.<sup>107</sup> Traditionally, the concept of an offset is not difficult.<sup>108</sup> Bank A loans Borrower \$10,000 and at the same time Borrower has \$5,000 deposited in Bank A.<sup>109</sup> If Bank A goes insolvent, the receiver is permitted to "offset" Borrower's deposit against his loan; that is, instead of paying out the \$5,000 deposit to Borrower as the receiver would normally be expected to do, it may subtract said deposit from Borrower's \$10,000 debt, thus leaving an amount outstanding of \$5,000 owed by Borrower to the receiver.<sup>110</sup> As one can imagine, this process can become infinitely more complex when considering a participating bank's interest in the loan.<sup>111</sup>

Initially upon encountering this problem with Penn Square Bank, the FDIC simply offset the deposits of its customers against their corresponding debts.<sup>112</sup> Participant banks complained, claiming that when the FDIC did this, it did not take into account the participatory interests that other banks owned in the loan; that is, the FDIC did not then turn around and pay a *pro rata* share of the offset to banks that had participated in loans held by the debtor.<sup>113</sup> They claimed that when the FDIC offset the loans, it should turn around and pay out the proceeds *pro rata* to the participating banks.<sup>114</sup> These participating banks argued that they had a specific interest in the loan and, through the offset, the FDIC was "canceling debt no longer owned by Penn Square . . ." <sup>115</sup> Thus, rather than getting an amount as close as practicable to their participation interest, they were given a portion that was significantly less than the amount they were owed.<sup>116</sup> The FDIC rejected this argument and continued with its plan of paying off the participating banks *pro rata* from the realized proceeds of Penn Square Bank's offsets.<sup>117</sup> These cases

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105. Singer, *supra* n. 13, at 155. For example, Michigan National had \$200 million in participations, of which more than half were either losses or anticipated losses. *Id.*

106. *Id.* at 155.

107. See Fisher, *supra* n. 29.

108. *Id.* at 760-761.

109. *Id.* at 761.

110. *Id.*

111. See generally *id.*

112. Fisher, *supra* n. 29, at 756.

113. *Id.* at 756-757.

114. FDIC, *supra* n. 14, at 535 n. 27.

115. Fisher, *supra* n. 29, at 757.

116. FDIC, *supra* n. 14, at 535 n. 27.

117. *Id.*

Loan participants usually receive their *pro rata* share of any payments made by a debtor that augments the receivership estate. The same holds true if the receiver forecloses on and liquidates the underlying collateral. Loan participations may suffer a loss greater than they would otherwise incur, however, if the debtors or receivers exercise their right of offset. Because the offset does not "augment the receivership estate," there are no proceeds to be passed on to the loan participants. The loan participants are therefore left with general unsecured claims against the receivership estate for the amounts they have lost as a result of the offset. The general unsecured claims are likely to be worth far less than the 100 cents on the dollar that direct proceeds or cash is worth.

*Id.*

were generally tried before courts that were confused by such complicated concepts.<sup>118</sup> The courts were unable to see the benefit derived by the receivership in the offsets (i.e., the FDIC was claiming assets in the offsets that were really the assets of the participating banks).<sup>119</sup> Therefore, many participating banks were unable to get their undiminished *pro rata* share from Penn Square Bank's deposits and were forced to write off huge amounts in losses.<sup>120</sup>

Unfortunately, no amount of lawsuits were enough to undo the damage that Penn Square Bank had caused, particularly since the courts were unwilling to question the FDIC's receivership policies.<sup>121</sup> Many of the upstream institutions had over-leveraged themselves on Penn Square Bank's assurances (and, it may be reasonably said, on their own lax implementation of due diligence).<sup>122</sup> As a result, a huge amount of capital had been inextricably tied up in Penn Square Bank originated loans.<sup>123</sup> When it proved too difficult for the participating banks to extricate themselves from this web of lending, the banking system of the entire country suffered.<sup>124</sup> Indeed, Penn Square Bank was just the tip of the proverbial iceberg when it came to insolvency.<sup>125</sup> Soon, a significant number of the nation's lending institutions had been placed on the FDIC's problem list.<sup>126</sup>

This phenomenon proved especially galling for the FDIC which, during the previous decades, had resolved only about six banks per year throughout the entire country.<sup>127</sup> After Penn Square Bank's demise, however, it wasn't long until banks all over the country became insolvent.<sup>128</sup> In Oklahoma and Texas, the two states where Penn Square Bank had been the most active, nearly all major banks as well as many smaller institutions such as savings and loans were forced under by the growing crisis.<sup>129</sup> The problems extended far outside of Penn Square Bank's region, as well.<sup>130</sup> The largest financial institution in the Northwest United States, Seattle First National Bank, became the first major national institution to be adversely affected by Penn Square Bank when it was forced to merge with BankAmerica Corporation.<sup>131</sup> In another region of the country, Continental Illinois Bank saw their non-performing loans (which mostly turned into losses) rise by nearly \$600 million because of its relationship with Penn Square Bank and eventually had to close its doors.<sup>132</sup> By the end of the crisis, upstream banks had lost over a billion dollars in loans and the insolvency had become the most expensive in

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118. Fisher, *supra* n. 29, at 837.

119. *Id.* at 838.

120. *Id.*

121. *See id.*

122. Singer, *supra* n. 13, at 154.

123. *Id.*

124. Harrell, *supra* n. 15, at 945–946; *see also* Sutton, *supra* n. 12 (arguing that changes in the regulatory schemes controlling savings and loans also played a significant role in the banking crisis of the 1980s).

125. *See* Harrell, *supra* n. 15, at 945–46.

126. Singer, *supra* n. 13, at 153.

127. Lovett, *supra* n. 23, at 137.

128. Harrell, *supra* n. 15, at 945.

129. *Id.*

130. *Id.*

131. FDIC, *supra* n. 14, at 542.

132. Singer, *supra* n. 13, at 158.

United States history.<sup>133</sup>

#### IV. PARALLELS TO TODAY: CAUSES OF THE CURRENT CRISIS

Like the collapse of Penn Square Bank, the subprime mortgage crisis was created by extraordinary circumstances.<sup>134</sup> While the effects of subprime lending have just now begun to be fully felt,<sup>135</sup> it is important to note that no consensus has yet been reached as to its immediate causes.<sup>136</sup> In most analyses on the subject, however, the blame falls on a complicated mixture of public policy, government regulation, and private greed,<sup>137</sup> the same formula that also lies at the heart of the Penn Square Bank saga.<sup>138</sup> Moreover, just like participations in the Penn Square Bank story, a financial instrument that was meant to diffuse risk played a major part in exacerbating the subprime mortgage crisis so much so that it would eventually engulf not only a nation, but the entire world.<sup>139</sup> In trying to untangle the web of causes, then, this section will sketch out a few factors that, at least in our present understanding, seem to have played a significant role in the economic turmoil surrounding the world's credit markets.

##### A. Public Policy

Some commentators have blamed the public policy of the federal government as the primary driver of the debacle, pointing to a series of regulations that Congress enacted over the last few decades.<sup>140</sup> Specifically, many single out the Community Reinvestment Act (CRA) passed in 1977 and later enhanced in the 1990s. This regulation was spurred through Congress by a wish to substantially grow the number of homeowners in the country.<sup>141</sup> In essence, it attempted to make housing affordable for people of all economic means by imposing certain restrictions and requirements on lending institutions.<sup>142</sup> For example, the CRA imposed "an affirmative duty [on lending institutions] to lend throughout the areas from which they take deposits, including poor neighborhoods."<sup>143</sup> In pursuit of these ends, as the criticism goes, banks were forced to find creative ways to finance loans for otherwise uncreditworthy customers who would never be capable of obtaining a mortgage without this law.<sup>144</sup> Thus, some critics contend that the rise in use of subprime loans was a direct consequence of these lending institutions trying as best they could to comply with a government regulation based on

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133. *Id.* at 189.

134. See R. Christopher Whalen, *The Subprime Crisis—Cause, Effect, and Consequences*, [http://papers.ssm.com/sol3/papers.cf.m?abstract\\_id=1113888](http://papers.ssm.com/sol3/papers.cf.m?abstract_id=1113888) (Mar. 1, 2008); Adelson, *supra* n. 3.

135. See Elliott, *supra* n. 1.

136. Compare Whalen, *supra* n. 134 with Robert Gordon, *Did Liberals Cause the Sub-Prime Crisis?* [http://www.prospect.org/cs/articles?article=did\\_liberals\\_cause\\_the\\_subprime\\_crisis](http://www.prospect.org/cs/articles?article=did_liberals_cause_the_subprime_crisis) (Apr. 7, 2008).

137. See Gordon, *supra* n. 136.

138. See Singer, *supra* n. 13.

139. See Peterson, *supra* n. 32.

140. See Whalen, *supra* n. 134; Gordon, *supra* n. 136.

141. Gordon, *supra* n. 136.

142. Whalen, *supra* n. 134, at 3–4.

143. Gordon, *supra* n. 136.

144. Whalen, *supra* n. 134, at 4.

the quixotic if not wholly unobtainable goal of universal home ownership.<sup>145</sup>

This view is not without its detractors.<sup>146</sup> For example, President Bush weakened the CRA in 2001 whereas the boom in the subprime loan industry came later in the decade.<sup>147</sup> Moreover, many of the subprime loans were not given in order to accommodate the CRA but were instead creatures of their own circumstances.<sup>148</sup> Rather than too much regulation, then, many critics have argued that there was, in fact, too little government interest in what was perceivably becoming a much larger problem.<sup>149</sup> Thus, instead of blaming a failed initiative of public policy, these critics blame disastrous choices in our nation's *fiscal* policy.

### B. *Fiscal Policy*

For example, critics have highlighted the permissive and anti-regulatory policies of the Federal Reserve Board (Fed) in the early 2000s as a primary culprit in the federal government's failure to prevent the crisis.<sup>150</sup> After the Dot-Com crash of 2000, the Fed cut short-term interest rates by 5.5 percent to smooth the correspondingly jittery economic conditions that followed.<sup>151</sup> This historically low rate combined with higher home values and engendered what is now known as the housing bubble.<sup>152</sup> This bubble had two effects: (1) it made real estate mortgages a more desirable commodity to banks and other lending institutions, and (2) it ensured a steady stream of money for the countless Americans who wished to take out these mortgages.<sup>153</sup> Many at the Fed were wary of the situation and there was some discussion as to whether the bubble should be artificially "popped" by raising the short-term interest rate so that the tide of "cheap" money behind the phenomenon would be stemmed.<sup>154</sup> But the prevailing argument held that bubbles were unavoidable, perhaps even undetectable,<sup>155</sup> and that the short-term interest rate should therefore never be used as a tool to pop suspected bubbles. Alan Greenspan, the Federal Reserve Chairman responsible for the sharp cut in the short-term interest rates, most succinctly captured the Fed's policy: "If the bursting of an asset bubble creates economic dislocation, then preventing bubbles might seem an attractive goal. But whether incipient bubbles can be detected in real time and whether, once detected, they can be defused without inadvertently precipitating still greater adverse consequences for the economy remain in doubt."<sup>156</sup> Therefore, interest rates remained

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145. *See id.*

146. Gordon, *supra* n. 136.

147. *Id.*

148. *Id.*

149. Katalina M. Bianco, *The Subprime Lending Crisis: Causes and Effects of the Mortgage Meltdown* 4–5, [http://www.business.cch.com/bankingfinance/focus/news/Subprime\\_WP\\_rev.pdf](http://www.business.cch.com/bankingfinance/focus/news/Subprime_WP_rev.pdf) (last accessed May 16, 2010).

150. Kara Scannell & Sandeep Reddy, *Greenspan Admits Errors to Hostile House Panel*, <http://online.wsj.com/article/SB122476545437862295.html> (Oct. 28, 2008).

151. Bianco, *supra* n. 149, at 4.

152. *Id.* at 4–5.

153. Peterson, *supra* n. 32, at 17.

154. Bianco, *supra* n. 149, at 4–5.

155. Tom Petrino, Money & Co.: Tracking the Market and Economic Trends That Shape Your Finances, *Bernanke Suggests a Shift at the Fed on Bubble-busting*, [http://latimesblogs.latimes.com/money\\_co/2008/10/imagine-a-bubbl.html](http://latimesblogs.latimes.com/money_co/2008/10/imagine-a-bubbl.html) (last accessed Oct. 15, 2008).

156. *Id.*

low and values in real estate continued their meteoric rise.

### C. *Subprime Loans*

Whatever the policy backdrop of the past decade may have been, the fact that subprime loans flourished during the early and middle parts of the decade is undisputed.<sup>157</sup> Subprime loans are typically offered to borrowers who have low credit at higher interest rates than prime loans.<sup>158</sup> They accounted for as much as 20 percent of those mortgages originating in 2006, creating an estimated \$600 billion dollars in risky debt.<sup>159</sup> The attractiveness of these loans to customers was evident; their popularity had grown to such an extent that, between 2001 and 2007, the average mortgage nearly doubled.<sup>160</sup> Not only were bank customers taking out mortgages to buy new houses, they were also borrowing against their current residence in the hopes of securing some easy cash under what they believed to be favorable terms.<sup>161</sup> Encouraged by the unprecedented rise in the housing market, banks and other lending institutions were more than willing to throw money at people with suspect credit confident that, if the borrower were to default, the value of the home would more than compensate the bank for the lost payments.<sup>162</sup> In this way, borrowers who in leaner times would have been denied a loan easily qualified under these relaxed lending standards.

### D. *Derivatives*

In addition to the government policies and runaway lending that fueled this housing bubble, financial instruments also played a major role in spreading out the threat that these subprime loans represented.<sup>163</sup> As is obvious from an analysis of the Penn Square Bank affair, the fallout from an institution's improvident loans spreads much more quickly when other institutions also hold an interest in these bad positions.<sup>164</sup> This is why, perhaps more than anything else, many critics point to a relatively new financial product, the derivative, when trying to allocate blame for the present credit crunch.<sup>165</sup>

Derivatives are often relegated to the realm of the esoteric as a super-complicated financial instrument that works in ways beyond easy comprehension,<sup>166</sup> but a basic understanding of their place in the economy and how they operate is essential to understanding the current situation. Essentially derivatives are what participations were to Penn Square Bank; they were a tool that created lending relationships between various institutions, a device whose primary goal was the spreading of risk, and an instrument that, in the end, has tied the whole financial industry together with too many toxic assets,

157. See Demyanyk, *supra* n. 4.

158. InvestorWords.com, Subprime Loan, [http://www.investorwords.com/6940/subprime\\_loan.html](http://www.investorwords.com/6940/subprime_loan.html) (last accessed May 25, 2010).

159. Bianco, *supra* n. 149, at 6.

160. Demyanyk & Hemert, *supra* n. 4, at 6.

161. *Id.* at 8.

162. Peterson, *supra* n. 32, at 17.

163. See Peterson, *supra* n. 32.

164. See Singer, *supra* n. 13.

165. See Jesse Eisinger, *The \$58 Trillion Elephant in the Room*, <http://www.portfolio.com/views/columns/wall-street/2008/10/15/Credit-Derivatives-Role-in-Crash> (Oct. 15, 2008).

166. See *id.*

crippling a fragile economy underneath its own weight.<sup>167</sup> Warren Buffet, the respected financial guru, surely recognized this when he famously referred to derivatives as “financial weapons of mass destruction.”<sup>168</sup>

Unlike a simple participation where the transaction is essentially limited to a lead bank and a participant, a derivative can have many players who enter at different times during the life of a loan.<sup>169</sup> There is, of course, an originating institution; i.e. someone must still go out, find potential borrowers, and draw up the loan’s terms and conditions.<sup>170</sup> In the case of participations, the originating institution retains the right to service these loans; this has not always been the case with derivatives.<sup>171</sup> Many times, the originating bank will simply assign the loan to another entity, reserving no ownership interest for itself at all.<sup>172</sup> Thus, the originator merely takes a finder’s fee and then quickly moves on to find another borrower to do the same, ultimately unconcerned with the performance of the loan sold.<sup>173</sup>

After a purchaser has corralled enough loans, it will then “pool” together many similar notes and put them into a special purpose vehicle (SPV).<sup>174</sup> Each SPV will then be divided up into “tranches,” or, in other words, “securities backed by a pool of cash-producing assets.”<sup>175</sup> These tranches will next be given ratings by a credit agency so that they can go out on the market as securities.<sup>176</sup> The highest ratings will typically go to those tranches that are the safest bets; that is, those tranches that are comprised of the loans’ principle and are therefore directly secured by collateral.<sup>177</sup> These tranches, in theory, are the least likely to encounter any problems.<sup>178</sup> In contrast, those tranches tied to the interest of the loans will understandably have the lowest ratings since, if any of the loans in the pool go into default, the expected income from interest payments will necessarily go down and the tranche will depreciate in value.<sup>179</sup> After the tranches are assigned a credit rating, they are ready to be offered on the market where they can be bought by other lending institutions, corporations, mutual funds, or any other organization or individual who is looking to invest in what at first seems to be a diversified, risk-limiting instrument.<sup>180</sup>

Like in Penn Square Bank’s case, many smaller institutions (as well as larger ones) were seduced by the prospect of lending out far more than they traditionally could by

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167. *See id.*

168. Dan Weil, *Rebuilding the House of Cards: What’s the Future for Much-Maligned Derivatives?* <http://www.thebigmoney.com/articles/making-bail/2008/10/15/rebuilding-house-cards> (Oct. 15, 2008).

169. *See* Peterson, *supra* n. 32, at 13.

170. *Id.* at 13.

171. *Id.* at 15.

172. *Id.*

173. *Id.* at 17.

174. Peterson, *supra* n. 32, at 14.

175. Eisinger, *supra* n. 165.

176. Peterson, *supra* n. 32, at 14–15.

177. *Id.* at 10.

178. *Id.*

179. *Id.* Much has been said about the culpability of the rating agencies in the current crisis, but such a topic is beyond the scope of this comment.

180. *Id.* at 17.



assigning loans to an eager, securitizing institution.<sup>181</sup> By claiming origination fees and then writing the loans off their books, these banks and lending institutions had to then continue lending in order to remain profitable.<sup>182</sup> Although home ownership increases almost every year, there was by no means an endless supply of credit-worthy individuals looking for a mortgage.<sup>183</sup> Therefore, lending institutions had to look to more risky borrowers to fill their quota.<sup>184</sup> Securitizing institutions didn't seem to mind.<sup>185</sup> As they saw it, real estate prices were going up astronomically;<sup>186</sup> any defaults would be cured by the value of the borrower's collateral and, if it was not, the tranches were sufficiently diversified to prevent any major disruption in their value.<sup>187</sup> Therefore, the utilization of this new tool created a massive incentive for lenders to take more risks.<sup>188</sup> Some CEOs were even criticized when they restrained their companies from acquiring or creating derivatives.<sup>189</sup> According to the reasoning of the marketplace, there was just too much money to be made and if your company was not taking advantage of derivatives, somebody else was and would eventually run you out of business.<sup>190</sup> Ironically, rather than protecting their companies, the CEOs who accepted this reasoning ensured their institution's demise when the housing bubble burst and the collateral that secured the by now ubiquitous derivatives plummeted in value, leaving little to be recouped by investors once mortgages started going into default.<sup>191</sup>

#### V. CONNECTING THE DOTS: PARTICIPATIONS AND DERIVATIVES

In many important ways, a derivative is not the same financial instrument as a participation.<sup>192</sup> A participation is usually purchased from the originating institution<sup>193</sup> whereas a derivative is most commonly purchased from a securities underwriter who obtained the loans from various originating institutions.<sup>194</sup> Also, derivatives are a "package" of loans, not merely an interest in one particular transaction.<sup>195</sup> Moreover, for the preceding reasons, it is much more unlikely that the purchaser of a derivative would have any substantive knowledge with respect to the loans that make up his or her investment.<sup>196</sup> Conversely, the purchaser of a participation can (and should) pursue his own due diligence in vetting the transaction underlying its investment.<sup>197</sup>

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181. Peterson, *supra* n. 32, at 16.

182. *Id.* at 17.

183. *Id.*

184. *Id.*

185. *See id.* at 15

186. *See* Bianco, *supra* n. 149, at 6.

187. Peterson, *supra* n. 32, at 16.

188. *Id.* at 17.

189. Charles Duhigg, *Pressured to Take More Risk, Fannie Reached Tipping Point*, [http://www.nytimes.com/2008/10/05/business/05fannie.html?\\_r=1&hp&oref=slogin](http://www.nytimes.com/2008/10/05/business/05fannie.html?_r=1&hp&oref=slogin) (Oct. 5, 2008).

190. *Id.*

191. *Id.*

192. *Compare* Peterson, *supra* n. 32, with Nassberg, *supra* n. 22, at 43.

193. Nassberg, *supra* n. 22, at 43.

194. *See* Peterson, *supra* n. 32, at 15.

195. Eisinger, *supra* n. 165.

196. *See id.*

197. Nassberg, *supra* n. 22, at 43.

Despite these differences, there are several similarities which suggest that these two instruments belong to the same genus. Under this theory, a derivative merely represents a more advanced iteration of a participation rather than a separate instrument altogether.<sup>198</sup> For example, both concepts share similar goals: they allow issuers to spread out risks, originators to lend more than they otherwise could, and purchasers to invest in loans that otherwise would not be available to them.<sup>199</sup> Furthermore, at their very heart, both participations and derivatives are offered and purchased on the same rationale; that is, all parties accept the fact that there is an underlying, secure collateral to the transaction that effectively insulates all parties from risk.<sup>200</sup> Under both concepts, then, an investor is simply purchasing an interest in a secured loan.<sup>201</sup> A derivative merely represents a “slice,” or tranche, representing an interest in a “pool” of loans rather than an interest in an undivided percentage of a single loan.<sup>202</sup> Such a concept makes it easier for investors to assess the relative worth and risk involved, at least in theory. Tranches with higher ratings are more trustworthy, lower rated tranches are obviously more risky.<sup>203</sup> In other words, with derivatives, the lead institution offers investors a choice in how they might wish to participate in a series of loans.<sup>204</sup>

The turmoil that the housing bubble and the diffusion of derivatives have caused is easily recognizable today.<sup>205</sup> Some of the giants in the financial industry, overleveraged on bad investments, have fallen, creating a vacuum where there was once readily available credit.<sup>206</sup> Just as Penn Square Bank failed when a fluctuating market left it with unpaid loans and significantly overvalued collateral, so, too, did many modern institutions fail on the mistaken notion that real estate and housing prices could never depreciate in value.<sup>207</sup> AIG, Lehman Brothers, Bear Sterns, Fannie Mae, Freddie Mac, and a host of others both large and small have disappeared by either taking the ignominious route of insolvency or, if they were somewhat luckier, by being acquired by another company (or the federal government) for pennies on the dollar.<sup>208</sup> Such high-profile failures have rocked people’s confidence in the world’s economy<sup>209</sup> and many commentators are relatively certain that the world is currently in a recession that could

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198. See 12 CFR 360.6 (where the FDIC treats participations and securities (i.e., derivatives) the same for purposes of receivership regulation).

199. See Lovett, *supra* n. 23, at 159; Eisinger, *supra* n. 165.

200. See Singer, *supra* n. 13; Peterson, *supra* n. 32.

201. See Singer, *supra* n. 13; Peterson, *supra* n. 32.

202. See Peterson, *supra* n. 32.

203. *Id.* at 10.

204. *Id.*

205. Matt Krantz, *Stocks End Rollercoaster Session Mixed; Dow Has Worst Weekly Drop Ever*, <http://abcnews.go.com/Business/story?id=6007613&page=1> (Oct. 13, 2008).

206. McKay, *supra* n. 8.

207. See Duhigg, *supra* n. 189.

208. McKay, *supra* n. 8.

209. *Id.* This is readily observable by looking at the various stock markets around the globe and their performance during the latter part of 2008. Krantz, *supra* n. 205. During one week, the Dow Industrial Average lost nearly 18 percent of its value; the European and Asian markets have not fared any better. *Id.* More importantly, perhaps, Libor, the indicator that determines the interest rate charged internationally for inter-bank lending, has risen to as high as 4.82 percent, a marked increase from the days before the crisis. The Economist, *A Painful Job to Do*, [http://www.economist.com/world/unitedstates/displayStory.cfm?story\\_id=12583077&source=features\\_box\\_main](http://www.economist.com/world/unitedstates/displayStory.cfm?story_id=12583077&source=features_box_main) (Oct. 18, 2008).

last until the end of the 2010.<sup>210</sup>

This retelling of what some might consider tired stories of boom and bust is not meant to highlight the moral flaws of the businessmen who helped dismantle their respective institutions or the greed of investors who bet on banks and bubbles and went down with them.<sup>211</sup> It is only meant to point out that a financial crisis cannot be reduced to heartless CEOs utilizing new, get-rich quick schemes that eventually leave tax-payers footing the bill when the gig is up.<sup>212</sup> Several factors led to Penn Square's failure: had the deregulation of gas prices and the energy crisis never occurred, there never would have been a corresponding spike in oil and gas prices, Jennings would never have been able to find backers for his loans, and upstream banks would have never become involved for lack of investment potential.<sup>213</sup> Analogously, "the sub-prime problem could not have happened without the housing bubble which, in turn, could not have happened without the Federal Reserve's accommodative interest rate policy of the early 2000s."<sup>214</sup>

In a world that is said to be ruled by supply and demand, bubbles are going to occur.<sup>215</sup> These bubbles, fueled by reckless speculation, will inevitably bring some investors and even some banks down when they burst.<sup>216</sup> Concepts such as the participation and the derivative, however, dramatically increase the risk that such an event will spread throughout the financial sector, leading to a system-wide paralysis that could reach an emergency reminiscent of the Depression.<sup>217</sup>

The accounts of both Penn Square Bank and the subprime crisis serve another purpose as well. With the enormity of the problems that such suspect activities create, it is very easy to lose one's perspective when it comes to finding a solution.<sup>218</sup> As in most financial crises, an instinctual reflex causes the public to blame those most closely associated with the fallout<sup>219</sup> and ignore the symptoms that preceded the crisis.<sup>220</sup> Once the "bad guys" have been punished, it is believed that prosperity and equilibrium will magically reappear. Penn Square Bank teaches us that this line of reasoning will not prevent future crises from appearing; after all, here we are again in much the same position.<sup>221</sup> The solution to the problem lies somewhere beyond punishing a few bad apple bankers who recklessly bet their deposits on shady schemes (though to be sure,

210. The Economist, *Wolves at the Door: Financial Mess and Gathering Recession Dominate Barack Obama's Economic Agenda*, [http://www.economist.com/displaystory.cfm?story\\_id=12551926](http://www.economist.com/displaystory.cfm?story_id=12551926) (Nov. 6, 2008).

211. See Singer, *supra* n. 13.

212. Goodman, *supra* n. 37. A quick search of the web reveals just such a sentiment welling up in response to the \$700 billion bailout being orchestrated by the federal government.

213. See generally Singer, *supra* n. 13.

214. Adelson, *supra* n. 3, at 2.

215. Sutton, *supra* n. 12, at 982.

216. See e.g. Singer, *supra* n. 13.

217. Cf. *id.*

218. Nina Easton, *Main Street Turns Against Wall Street*, [http://money.cnn.com/2008/09/26/news/economy/easton\\_backlash.fortune/index.htm?postversion=2008092810&eref=rss\\_topstories](http://money.cnn.com/2008/09/26/news/economy/easton_backlash.fortune/index.htm?postversion=2008092810&eref=rss_topstories) (last updated Sept. 28, 2008).

219. *Id.*

220. See Adelson, *supra* n. 3, at 2.

221. Zweig, *supra* n. 55, at 960. In regards to preventing future crises, two phenomena, one old and one new, make this difficult if not impossible. First, ". . . trouble always comes through the window you are not watching." Second, ". . . the investigative resources of our nation, both governmental and media [sic] are stretched perilously thin." *Id.*

some punishment is warranted). We should instead turn our attention to the fact that Penn Square Bank and the current crisis were grossly exaggerated by financial instruments that were gobbled up by institutions either unaware or uninterested in the underlying collateral and the lead bank's ability to make sound lending decisions. Therefore, regulations should be promulgated to control the formation and oversight of such unpredictable transactions. Moreover, it is evident that existing receivership regulations are not sufficient to manage the losses of upstream banks when a lead bank fails and they, too, should be modified accordingly.<sup>222</sup>

## VI. REGULATING RISK SHARING

Participations and derivatives are both presently ineluctable parts of the American financial system.<sup>223</sup> In factm the benefits of such concepts are palpable.<sup>224</sup> Both instruments allow a bank to lend to credit-worthy borrowers who are seeking a loan in excess of what that bank may be capable of financing under federal regulations.<sup>225</sup> This ability means increased profits for a bank where otherwise there would be none.<sup>226</sup> Moreover, that bank can maintain a relationship with its local clientele and not lose business to larger banks with more capital on-hand.<sup>227</sup> These instruments also help banks that share fractional interests in the loan, giving them access to investments and profits that would not be available under normal circumstances.<sup>228</sup> Banks are therefore able to diversify their loan portfolios by lending outside of their traditional regions, thereby effectively insulating themselves from the risk of being too concentrated in any one geographic area or industry.<sup>229</sup>

As this article has endeavored to show, however, any instrument that shares debt is capable of bringing this country's economy to its knees.<sup>230</sup> Many banks and other lending institutions have consistently abused this concept of reaping increased revenues from the servicing of loans while enjoying the benefits of not having to count said loans against their federally regulated capital requirements.<sup>231</sup> Such overreaching has often led to gaudy profits in the past.<sup>232</sup> This, in turn, has compelled banks to begin lending at increased levels.<sup>233</sup> In such circumstances, the more borrowers that such an institution finds, the more income it realizes.<sup>234</sup> Institutions that no longer make money off of loans in the traditional sense (that is, they no longer counts on the steady repayment of the

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222. See Fisher, *supra* n. 29. Unlike other suggested reforms, this Article will not pass on the soundness of ideas such as creating a transparent market for derivatives trading or banning the instrument altogether. See e.g. David Cho & Zachary A. Goldfarb, *U.S. Pushes Ahead with Derivatives Regulation*, <http://www.washingtonpost.com/wp-dyn/content/article/2009/05/13/AR2009051302393.html> (May 14, 2010).

223. Lovett, *supra* n. 23, at 159.

224. See *id.*

225. *Id.*

226. See Singer, *supra* n. 13, at 20.

227. Cf. Lovett, *supra* n. 23, at 158–159.

228. Cf. *id.*

229. *Id.*

230. See Singer, *supra* n. 13; Peterson, *supra* n. 32.

231. Peterson, *supra* n. 32, at 17.

232. Eisinger, *supra* n. 165.

233. Peterson, *supra* n. 32, at 17.

234. *Id.*

loan's principal along with the profit-bearing interest<sup>235</sup>) become lending factories, deriving profit from the generation of loans while leaving others to profit from the loan itself.<sup>236</sup> The originating institutions quickly lose interest in closely scrutinizing the quality of a borrower's credit or the value of a loan's underlying collateral. Moreover, the originating institutions no longer care about what happens to a loan after it has been made in such a scheme; whether a loan is paid off or goes into default, for an originating institution, the results are the same.<sup>237</sup>

Presently, there are few regulations that govern the use of participations and even fewer restricting derivatives. The only direct restraint on a national bank's lending is that imposed by its own capital. Federal regulations prohibit a bank from lending more than 15 percent of its unimpaired capital to one borrower.<sup>238</sup> This amount may be augmented by a further 10 percent if those amounts over the standard limit are fully secured by some form of collateral (i.e., the value of the loan is no more than 100 percent of the value of the collateral).<sup>239</sup> This regulation is actually intended to force banks into financial partnerships such as participation agreements by preventing small banks from lending out too much to one individual.<sup>240</sup> As we have seen time and again, however, it is not sufficient in and of itself to prevent the over-leveraging of financial institutions.

In order to prevent risky and ungovernable loans, two regulatory additions should augment the current regulations that tie a bank's loans to its capital reserves. First, federal banking laws should require an originating institution to retain at least a nominal interest in the loan for the loans entire term. The percentage could be set as low as 5 percent or even as high as 15 percent. While a flat percentage is enviable over no retention requirement at all, a more helpful model would include a sliding scale. For those loans that represent the least amount of risk, the originating institution would be able to sell or assign a larger portion of the loan. Conversely, a loan such as a subprime mortgage would require the bank to own a higher percentage of interest and thus a higher percentage of the risk.

Whatever methodology the regulation employs, such a requirement would help banks meet two critical goals. First, because it is keeping an interest in the loan, the bank will have a greater impetus to lend to credit-worthy individuals. Gone would be the days where an institution simply gathered its finder's fee and packaged the loan off along with the risk to a buyer who has no first-hand knowledge of the collateral or the borrower. Faced with the reality of losing even a relatively small percentage of a loan, a bank will be more hesitant to engage in risky lending activity. Second, the regulations will require an originating bank to have an interest in the loan for its entire life-span, thus ensuring a close connection between lender and borrower that will better allow for the monitoring and adjusting of the loan over time.

The second new regulation should affect the rules regarding a bank's acceptance of collateral. Rather than having a pure value for value ratio between the collateral and the

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235. *Id.*

236. See Singer, *supra* n. 13, at 19.

237. Peterson, *supra* n. 32, at 17.

238. 12 U.S.C. § 84(a).

239. 12 U.S.C. § 84(b).

240. Lovett, *supra* n. 23, at 159.

loan, there should be a requirement that the collateral exceed in value the amount of the loan. A small 5 or 10 percent overage would protect banks against a foreseeable depreciation in the value of the collateral. The FDIC, however, should have the power to raise this percentage for any class of collateral that exhibits a marked increase. Thus, if the increase turns into a bubble which later bursts, the risk that the collateral's value would not cover the amount left outstanding on the loan would be greatly diminished. This flexibility will also help prevent bubbles since a rise in a bank's risk will doubtlessly encourage it to rein in any suspect lending. This would mean the death knell for "no money down" loans for cars, homes, or other large purchases, but judging from the problems recently associated with these products, such an outcome may not be completely undesirable.

#### VII. REGULATING RECEIVERSHIPS

The preceding regulations are designed to give banks and other lending institutions some faith that, when they become involved in a lead bank's transaction, they will run the same risks as the lead bank. This should be a bedrock principle for transactions that by their very nature spread risk and, correspondingly, the participating banks should be paid *pro rata* from any collected proceeds from the borrower's payments. Moreover, if the loan should go into default, they should share in the profits derived from the sale of the loan's underlying collateral. Finally, this principle should also be enshrined in the duties of a receiver if and when the lead bank itself goes into insolvency.

In such situations, by allowing participating banks to realize as much return on their investments as possible, it will be more likely that they themselves will not succumb to the same fate as their business partner, the lead bank. In the subprime mortgage crisis, it is still too soon to determine how participating banks will fair under a lead bank's receivership. If the chaos that resulted from Penn Square Bank's receivership proves prescient, it is probable that they will not fare well.<sup>241</sup> Therefore, there should be new regulations that will ensure that participating banks are able to minimize their losses no matter what the circumstances of the lead bank might happen to be. Such regulations will help keep localized crises from spreading too far beyond their epicenter and will keep investors calm in times of economic uncertainty.

Several relatively recent regulations have gone a long way to curing some of the defects that have previously marred the receiverships of lead banks.<sup>242</sup> The first change involves the Uniform Commercial Code's (UCC) Article 9 dealing with secured transactions. Traditionally, loan participations or assignments have not enjoyed the status of a secured investment.<sup>243</sup> Under the current revision of Article 9 (enacted in all 50 states), a security interest includes, "[a] sale of an account, chattel paper, a promissory note, or a payment intangible."<sup>244</sup> Such transactions would "include[ the] sale of a right

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241. *See supra* pt. III.

242. *See* Frank H. Reeves, *Bank Loan Participations under the Federal Deposit Insurance Act and Revised Article 9*, 119 *Banking L. J.* 174 (2002).

243. *Hibernia Natl. Bank*, 733 F.2d at 1407.

244. U.C.C. § 9-109(3) (2002).

in [a] receivable, such as a sale of a participation interest.”<sup>245</sup> According to the UCC, if a participating bank ensures that the participation is in writing and “perfected,” it will then have a secured interest in the loan.<sup>246</sup> It is not within the scope of this article to explain the relatively complicated process of participation securitization, but it should suffice to say that many participations are now secured interests.<sup>247</sup> This new distinction is important in that it allows participants to go to the head of the line in the event of a lead bank’s insolvency.<sup>248</sup> No longer are they relegated to the status of a general creditor as they typically were before this new regulation, therefore ensuring that they run substantially less risk of not recouping their investment.<sup>249</sup>

To further this end, the Federal Government has drafted § 360.6 in Article 12 of the Code of Federal Regulations (CFR).<sup>250</sup> Under the Federal Deposit Insurer’s Act, the FDIC has the power of disaffirming or repudiating contracts that are held by an insolvent bank in order to administer the receivership as effectively as possible.<sup>251</sup> Section 360.6, however, expressly forbids the FDIC from exercising this power to “reclaim, recover, or recharacterize as property of the institution or the receivership any financial assets transferred by an insured depository institution in connection with a securitization or participation.”<sup>252</sup> Therefore, participant banks are now assured that the FDIC, acting in its power as a receiver, will not do anything to detrimentally affect their interest in a loan.<sup>253</sup>

Despite these positive changes in the treatment of participations, there may still be refinements that the FDIC can make that will further ensure that a participating bank realizes a significant, if not total, return on its investment. This is especially true when the participant has relied on a lead bank’s faulty or fraudulent determinations. First, if a loan is in danger of going into default or is, in fact, already there, the FDIC should determine whether the instrument can be reformed so that the borrower may continue to make payments.<sup>254</sup> The FDIC has been slow to pursue this path in the past,<sup>255</sup> instead, it has long been the FDIC’s settled policy to resolve an insolvent bank as quickly as possible. It should finally be apparent, however, that such a policy does not adequately protect the banking system as a whole.<sup>256</sup> Foreclosed properties and unnecessary bank losses are, as the subprime mortgage crisis bears out, recipes for disaster.<sup>257</sup> Therefore,

245. *Id.* at § 9-109 n. 5.

246. *Id.* at § 9.

247. *See Reeves, supra* n. 242.

248. *Id.*

249. *Id.*

250. *Id.*

251. 12 U.S.C. 1821(e) (2009).

252. 12 C.F.R. 360.6(b) (2000).

253. *See Bank of N.Y. v. FDIC*, 508 F. 3d 1 (D.C. Cir. 2007). This is the only case that has utilized this new regulation. A trustee for participant banks sued the FDIC in its capacity as a receiver for an insolvent bank. Essentially, it claimed that the FDIC’s disregard of an acceleration clause in the notes constituted a repudiation. The court ruled that it did not. *Id.*

254. *See Jeanne Sahadi, Indymac Borrowers to Get Relief*, [http://money.cnn.com/2008/08/20/real\\_estate/fdic\\_indymac\\_mods/index.htm](http://money.cnn.com/2008/08/20/real_estate/fdic_indymac_mods/index.htm) (Aug. 20, 2008). The FDIC is currently experimenting with reforming loans in its receivership for Indymac Bank. *Id.*

255. *See Cheatham, supra* n. 98, at 1056.

256. *See generally Singer, supra* n. 13.

257. *See Bianco, supra* n. 149.

the FDIC should create an entity into which it might transfer some of these “toxic” assets that no other bank or institution is willing to buy and service. This entity, acting as a lead bank, may then reform the troubled instruments so that the borrower will have a fair chance of keeping his property and the participant might be able to realize a return. This policy would require that the special entity buy the insolvent bank’s portion of the loan so that it may be liquidated with the rest of said bank’s assets. While such a cost is surely not welcomed by the FDIC,<sup>258</sup> it would seem to be far more preferable (as well as more affordable) than bailing out financial institutions once the crisis has spread beyond containment.<sup>259</sup> With this interest disposed of, the FDIC would be free to wrap up the receivership as quickly as it wishes. The interests of the participating banks would still be secure, but now the burden of servicing the loan and, if necessary, liquidating the collateral, would be placed on this new entity. While this will not completely eliminate a participant’s losses (when, for example, a borrower goes into default and the underlying collateral proves to be undervalued), it may significantly lower them.

Another possible refinement could lie in the FDIC’s treatment of the offset. *Hibernia Nat. Bank v. FDIC.*, a case arising from the Penn Square Bank debacle, provides a typical example of the FDIC’s standard operating procedures when dealing with offsets.<sup>260</sup> *Hibernia* very clearly rejects the notion that participating banks are entitled to a *pro rata* share of any offset that a receiver secures for a borrower.<sup>261</sup> There the court held that “an offset is not a payment but merely a setting-off against the loan of previously established credits . . . . Moreover, “such an offset is insufficient to establish a fund which the claimant may call its own.”<sup>262</sup> The concept is more fully fleshed out in an earlier case which provided *Hibernia*’s rationale, *FDIC v. Mademoiselle*.<sup>263</sup> In *Mademoiselle*, the court determined that a participant may only share in the offset if there was an “augmentation of the bank’s assets.”<sup>264</sup> When a receivership eliminates or reduces a debt by offsetting the borrower’s deposits, that bank’s assets are reduced but the receivership is no longer bound to paying out the borrower’s insured deposits.<sup>265</sup> In practice, this means that a participant is almost never allowed to recoup funds from the offset.<sup>266</sup>

To avoid such confusion with offsets, it should be the settled policy of an FDIC receivership that all participating institutions are qualified to receive a *pro rata* share of any offset provided certain conditions are met. Such formalities as “augmentations” should be ignored and, in keeping with the fact that many participations now hold the status of a secured interest, an offset should be available as a source from which a

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258. Here it should be noted that, among payees, the FDIC stands at the head of an insolvent institution’s line so that it is assured to receive recompense for its administrative costs before any other depositor or creditor is paid. FDIC, *supra* n. 77, at 72. Therefore, I would foresee the entity that is set up to deal with toxic assets as having its own operating budget that would ideally be financed by the profit it is able to turn on the loans.

259. See Daniel Gross, *The Bailout Will Be a Bargain*, <http://www.slate.com/id/2195308/> (July 14, 2008).

260. *Hibernia Natl. Bank*, 733 F. 2d 1403.

261. *Id.*

262. *Id.* at 1408.

263. *FDIC v. Mademoiselle*, 379 F. 2d 660 (9<sup>th</sup> Cir. 1967).

264. *Id.* at 666.

265. *Id.*

266. *Id.*



participant can look to limit or eliminate its losses. This right, however, should only arise when it is clear that the participating institutions will not be able to recoup their investment from the loan itself (i.e., from payments made by the borrower). Thus, the FDIC would have to act swiftly in evaluating the soundness of an insolvent institution's loans. It should then sell the healthy loans, reform the salvageable loans, and allow participants a *pro rata* share of the offset for those loans which are beyond hope.

#### VIII. CONCLUSION

The banking industry is integral to our economic system.<sup>267</sup> Without it, small businesses would be unable to prosper, large corporations would not be able to exist, and most Americans would never be capable of buying a home.<sup>268</sup> The invention and utilization of credit, which some laud as the most important financial concept ever conceived, has allowed all of this.<sup>269</sup> This system does not, however, come without its problems.<sup>270</sup> As banks have evolved from simple, regional depository and lending institutions into corporations in search of ever-swelling bottom lines, the risks to our financial system and economy have grown exponentially. Ironically, rules and instruments that are intended to spread and diffuse these risks have also been shown to possess the ability to do grave damage to our entire banking industry.<sup>271</sup> Therefore, remedial regulations such as those set out in this article should be enacted to ensure that no future bubble or pricing irregularity causes another Penn Square Bank or subprime mortgage crisis and brings this country and its economy to a grinding halt.<sup>272</sup>

Our country has an enormous faith in our banks, but when these institutions begin taking risks that threaten not just their own existence but also the financial stability of their customers, the government should step in to reestablish the public's good will. Regulations such as those described above should be promulgated with an eye towards limiting both the risks that customers take when depositing their money or taking out a loan as well as the risks that banks take while facilitating such actions. If there are too many Penn Square Banks or subprime mortgage crises, it is not inconceivable that a system designed to facilitate and grow wealth will end up destroying the very fabric of our economy, the faith and good-will of the American people who depend on it.

—Jared M. Burden\*

267. Allister Heath, *Survival of the Fittest*, [http://www.literaryreview.co.uk/heath\\_11\\_08.html](http://www.literaryreview.co.uk/heath_11_08.html) (Nov. 2008).

268. Lovett, *supra* n. 23, at 1.

269. Heath, *supra* n. 267.

270. See John Steel Gordon, *The Madness of Crowds*, <http://www.commentarymagazine.com/viewarticle.cfm/speculators--politicians--and-financial-disasters-13180> (Nov. 2008) (describing a 19th century crisis similar to that created by the subprime mortgage industry).

271. See *supra* pts. VI–VII.

272. Peterson, *supra* n. 32, at 17.

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