

## The Legacy of Deregulation and the Financial Crisis: Linkages Between Deregulation in Labor Markets, Housing Finance Markets, and the Broader Financial Markets

Damon Silvers

Heather Slavkin

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# The Legacy of Deregulation and the Financial Crisis—Linkages Between Deregulation in Labor Markets, Housing Finance Markets, and the Broader Financial Markets

<b>I. DEREGULATION OF LABOR MARKETS</b> .....	304
A. <i>The Erosion of the Collective Bargaining System</i> .....	304
B. <i>Wage and Hour Laws</i> .....	308
C. <i>The Decline of the Progressive Tax System</i> .....	312
D. <i>Consequences: Stagnant Real Wages, Rising Inequality, Falling Savings Rates</i> .....	315
<b>II. DEREGULATION OF THE RESIDENTIAL MORTGAGE MARKETS</b> .....	316
A. <i>History of U.S. Mortgage Regulation</i> .....	316
B. <i>Deregulation of Mortgage Markets</i> .....	320
C. <i>Preemption of State Consumer Protection Laws</i> .....	323
D. <i>GSEs—Privatizing Public Institutions</i> .....	325
E. <i>The Explosion of Subprime Lending</i> .....	328
F. <i>The Community Reinvestment Act and the Subprime Bubble</i> ...	329
G. <i>Conclusions</i> .....	332
<b>III. FINANCIAL MARKET DEREGULATION AND THE CREATION OF THE SHADOW FINANCIAL SYSTEM</b> .....	332
A. <i>Early Stages of Deregulation</i> .....	332
B. <i>Securitization</i> .....	334
C. <i>Shadow Financial Markets</i> .....	337
D. <i>The End of Glass-Steagall</i> .....	340
<b>IV. CONCLUSION</b> .....	341
<b>APPENDIX A—PRIVATE SECTOR UNION DENSITY</b> .....	342
<b>APPENDIX B—WAGES AND PRODUCTIVITY</b> .....	342
<b>APPENDIX C—PENSION COVERAGE AND UNION DENSITY</b> .....	343

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\* Damon Silvers is an Associate General Counsel, AFL-CIO; Deputy Chair of the Congressional Oversight Panel, overseeing the Treasury Department's implementation of the Emergency Economic Stabilization Act of 2008. Heather Slavkin is the Senior Legal and Policy Advisor, AFL-CIO Office of Investment. The views as expressed in this article are the authors' alone and not those of the AFL-CIO or the Congressional Oversight Panel.

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THE LEGACY OF DEREGULATION AND THE FINANCIAL CRISIS

APPENDIX D—CONSUMER SPENDING AND UNION DENSITY ..... 344  
APPENDIX E—REAL DOLLAR VALUE OF THE MINIMUM WAGE ..... 345  
APPENDIX F—GROWTH IN INEQUALITY ..... 346  
APPENDIX G—INVESTOR SHARE OF SECURITISATION PRODUCTS..... 347  
APPENDIX H—EFFECT OF REGULATION ON THE AMERICAN FINANCIAL  
SYSTEM ..... 347

THIS ARTICLE EXAMINES DEREGULATION’S CONTRIBUTION to the financial crisis that began in the spring of 2007. We begin with the view that the financial crisis was not an unpredictable, unforeseeable event that landed on the global economy from nowhere. Rather, it was the all too foreseeable consequence of a series of policy decisions made over decades that weakened a carefully constructed economic regulatory structure designed in part to guard the U.S. economy against the consequences of radical instability in the financial markets.<sup>1</sup>

While much attention has been given to a variety of gaps in the financial regulatory system, this article looks at those gaps as only the most immediate cause of the financial crisis. We see the financial crisis as ultimately stemming from the effort to use finance, and in particular consumer debt, as a strategy for counteracting the effects of stagnating incomes and increased inequality of wealth.

Consequently, this paper seeks to trace the key deregulatory decisions in three markets—labor markets, home mortgage markets, and finally, the broader financial markets with particular attention to the institutions involved in constituting the secondary and tertiary markets in securities derived from home mortgages.

Our purpose is to provide an overview of key legal developments in three distinct areas—labor market regulation and basic individual income tax policy, home mortgage regulation, and financial markets regulation. The underlying

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1. This New Deal regulatory structure included the Banking Act of 1933, ch. 89, 48 Stat. 162 (codified as amended at 12 U.S.C. §§ 1811–1832 (2006)) (commonly referred to as the Glass-Steagall Act); the Securities Act of 1933, ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a–77aa (2006)); the Banking Act of 1935, ch. 614, 49 Stat. 684 (codified as amended in scattered sections of 12 U.S.C.); the Trust Indenture Act of 1939, ch. 411, 53 Stat. 1149 (codified at 15 U.S.C. §§ 77aaa–77bbbb (2006)); the Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. § 78a (2006)); the Investment Company Act of 1940, ch. 686, 54 Stat. 789 (codified as amended at 15 U.S.C. §§ 80a-1 to 80a-64 (2006)); and the Investment Advisors Act of 1940, ch. 686, 54 Stat. 847 (codified as amended at 15 U.S.C. §§ 80b-1 to 80b-21 (2006)); the Public Utility Act of 1935, ch. 687, 49 Stat. 803, *repealed by* Public Utility Holding Act of 2005, 42 U.S.C. § 16451, et. seq. (2005). For a history of the weakening of this structure, see ROBERT KUTTNER, *THE SQUANDERING OF AMERICA: HOW THE FAILURE OF OUR POLITICS UNDERMINES OUR PROSPERITY* 3–15 (2007) (providing a detailed analysis of how modern politics and economic policies in the United States led to a nationwide decline in prosperity); and JOSEPH E. STIGLITZ, *THE ROARING NINETIES: A NEW HISTORY OF THE WORLD’S MOST PROSPEROUS DECADE* (2003) (analyzing how the Federal Reserve, deregulation, creative accounting, tax cuts, and private industry each had a role in the corporate scandals and financial burst that occurred in the 1990s and early 2000s); see also Steven A. Ramirez, *The Law and Macroeconomics of the New Deal at 70*, 62 MD. L. REV. 515, 534–46 (2003) (explaining the role played by the Securities Act of 1933, the Banking Act of 1933, and the Banking Act of 1935 in the New Deal).

theory of the article is that weak labor market regulation led to stagnant real wages, growing inequality and falling savings rates even as aggregate wealth and productivity grew dramatically. These trends weakened consumer demand, and led to a variety of pressures to make credit provision easier as a method of bolstering consumer spending and protecting households from the full consequences of stagnant wages.<sup>2</sup> As these trends intensified, financial transactions contributed a larger and larger share of U.S. economic activity, and financial firms contributed more and more disproportionately to overall U.S. corporate profits.<sup>3</sup> In this environment, the political pressures for further financial deregulation were irresistible.<sup>4</sup>

This analysis is of course necessarily incomplete. We have not chosen to address a number of critical areas of this analysis, including the role played by trade liberalization, the recent history of safety and soundness regulation in the banking sector, and the complex history of state-federal interaction in regard to consumer protection issues in financial services.<sup>5</sup> Each of these issues is quite significant, but limitations of space and time preclude addressing them in the manner they each deserve.

In each area we address, our purpose is to give the reader a sense of the deregulatory direction of public policy, and some of the consequences of that direction. Our aim is not a comprehensive history, but rather a kind of map of how

2. See generally CHRISTIAN E. WELLER, *DROWNING IN DEBT: AMERICA'S MIDDLE CLASS FALLS DEEPER IN DEBT AS INCOME GROWTH SLOWS AND COSTS CLIMB* (2006), available at <http://www.americanprogress.org/kf/boomburden-web.pdf>.

3. Financial activity, including insurance, accounted for 8.1% of the United States gross domestic product in 2006, which represents a 40% increase since 1980. BUREAU OF ECONOMIC ANALYSIS, *GROSS-DOMESTIC-PRODUCT-BY-INDUSTRY ACCOUNTS*, [http://www.bea.gov/industry/gpotables/gpo\\_action.cfm?anon=88262&table\\_id=23975&format\\_type=0](http://www.bea.gov/industry/gpotables/gpo_action.cfm?anon=88262&table_id=23975&format_type=0) (last visited Feb. 25, 2009). Since 1999, financial companies regularly provided a disproportionate share of the Standard & Poor's 500 average per-share earnings, at times nearly doubling the share of the second highest industry group. David Gaffen, *The Profit Picture Remains Ugly—After Dismal 2008, Quick Rebound Unlikely; Will Health Care Be the Rx?*, WALL ST. J., Feb. 9, 2009, at C1, available at <http://online.wsj.com/article/SB123412201560361003.html>.

4. See Sanford M. Jacoby, *Finance and Labor: Perspectives on Risk, Inequality, and Democracy*, 30 *COMP. LAB. L. & POL'Y J.* 17, 19–20, 32 (2008).

5. Generally, "trade liberalization refers to a process of interstate cooperation laid down by an international trade agreement aimed at disciplining governmental measures and practices that restrict foreign goods' or services' access to domestic markets or impair the competitive relationship between foreign goods or services [and] like domestic goods and services." Gabriel Gari, *Legal Instruments for the Liberalization of Trade in Services at the Sub-Regional Level: The MERCOSUR Case*, 25 *PENN ST. INT'L L. REV.* 659, 666 (2007). Several federal administrative agencies, including the Office of Thrift Supervision, the Federal Reserve, the Federal Deposit Insurance Company, the Federal Housing Finance Agency and the Office of the Comptroller of the Currency are charged with ensuring the safety and soundness of the financial institutions they regulate. 12 U.S.C. §§ 1463, 4513. For reports of recent failures of this regulatory framework, see Binyamin Appelbaum & Ellen Nakashima, *Banking Regulator Played Advocate Over Enforcer; Agency Let Lenders Grow Out of Control, Then Fail*, WASH. POST, Nov. 23, 2008, at A1; Zachary A. Goldfarb, *Mixed Signals for Mortgage Giants; Despite Exceeding Requirements, Firms Called Undercapitalized*, WASH. POST, Oct. 10, 2008, at D2. For a discussion of state and federal authority over consumer protection in financial services, see generally Elizabeth R. Schlitz, *Damming Watters: Channeling the Power of Federal Preemption of State Consumer Banking Laws*, 35 *FLA. ST. U. L. REV.* 893 (2008).

the deregulatory impulse fed upon itself, and in ways that might not be immediately obvious, made our economy and our society more dependent on unsustainable financial practices, and more vulnerable to the inevitable denouement that followed on the heels of the growth of those practices.

## I. DEREGULATION OF LABOR MARKETS

The New Deal and World War II produced a fairly high degree of regulation in both labor and capital markets, augmented by a progressive income tax system.<sup>6</sup> This regulatory structure was designed to prevent the reoccurrence of the Great Depression by ensuring stable, widespread consumer demand through regulated labor markets, and in parallel capital market regulation aimed at meeting the demand for both expensive consumer goods (homes and cars) and for business financing with a minimum amount of instability.<sup>7</sup>

In the area of labor market regulation, the key elements were a legally established system of private sector collective bargaining, a system of wage and hour regulation including the minimum wage and the forty hour week, enforced by the Federal Department of Labor, and finally, a progressive tax system.<sup>8</sup>

### A. *The Erosion of the Collective Bargaining System*

The promotion of collective bargaining as a means of resolving labor disputes was enshrined in law in the National Labor Relations Act.<sup>9</sup> However, the key methods used by unions to organize new workplaces during their period of greatest growth—the sit down strike and the secondary boycott—were outlawed by 1948.<sup>10</sup> These developments had long-term implications for the ability of labor unions to organize workers as economic activity shifted from region to region within the United States, as industries changed, and finally, as the economy moved from a predominantly industrial economy to a predominantly service sector economy.<sup>11</sup>

6. See generally Robert L. Rabin, *Federal Regulation in Historical Perspective*, 38 STAN. L. REV. 1189, 1192 (1986) (providing a historical analysis of how the New Deal drastically changed federal regulation).

7. See *id.* at 1243–44, 1246–52 (describing how the New Deal responded to the Great Depression by allowing the federal government to regulate labor, business, and the economy).

8. The National Labor Relations Act established a system of private sector collective bargaining. 29 U.S.C. §§ 157–169 (2006). The Fair Labor Standards Act established wage and hour rules such as the minimum wage and the forty hour work week. 29 U.S.C. §§ 201–219; see also Internal Revenue Code, 26 U.S.C. § 1 (2000).

9. 29 U.S.C. §§ 157–169 (2006).

10. *NLRB v. Fansteel Metallurgical Corp.*, 306 U.S. 240, 256 (1939) (holding that a sit-down strike was not protected concerted activity). The Labor Management Relations Act outlawed secondary boycotts and other forms of concerted activity. 29 U.S.C. §§ 158(b)(4), 187 (2006) (also known as the Taft-Hartley Act). See generally Karl E. Klare, *Judicial Deradicalization of the Wagner Act and the Origins of Modern Legal Consciousness, 1937–1941*, 62 MINN. L. REV. 265 (1978) (describing how the conservative federal judiciary eviscerated the National Labor Relations Act).

11. Jacoby, *supra* note 4, at 45 n.58; Samuel Estreicher, *Labor Law Reform in a World of Competitive Product Markets*, 69 CHI.-KENT L. REV. 3, 6 (1993).

While the National Labor Relations Act provided for union representation elections under “laboratory conditions,” the lack of financial penalties for violating these conditions created incentives for employers to create hostile environments surrounding union representation elections in the private sector.<sup>12</sup> As a result, union organizing efforts in the private sector, particularly in companies or industries with low union density, have not as a general matter been marked by success, and the long-term trend in union membership as a percentage of the workforce has been declining since the early 1950s.<sup>13</sup>

However, notwithstanding the slow erosion of union density, the collective bargaining system remained a central feature of private sector U.S. labor relations through the 1970s, with collective bargaining setting wages and benefits in manufacturing, mining, transportation, construction and certain key service sectors like retail food workers and the entertainment industry.<sup>14</sup>

The collective bargaining system in this period was marked by a regulatory philosophy that sought to make strikes and lockouts a useable but costly tactic for both labor and management.<sup>15</sup> Among the legal doctrines deployed in pursuit of this objective was the concept that strikers could not be fired.<sup>16</sup> Thus, in a strike, workers would suffer a loss of income, but would not be under the pressure of losing their jobs.<sup>17</sup> Statutory provisions such as the ban on secondary boycotts were de-

12. 29 U.S.C. § 159; *NLRB v. Gissel Packing Co.*, 395 U.S. 575, 612 (1969) (holding that where an employer has “destroy[ed] the laboratory conditions necessary for a fair election,” the National Labor Relations Board has the authority to order that employer to bargain with the union); *In re General Shoe Corp.*, 77 N.L.R.B. 124, 127 (1948) (“[I]t is the Board’s function to provide a laboratory in which an experiment may be conducted, under conditions as nearly ideal as possible, to determine the uninhibited desires of the employees.”); see also COMM’N ON THE FUTURE OF WORKER-MGMT. RELATIONS, DUNLOP COMM’N ON THE FUTURE OF WORKER-MGMT. RELATIONS—FINAL REPORT 38–39, 42 (1994), available at [http://digitalcommons.ilr.cornell.edu/key\\_workplace/2](http://digitalcommons.ilr.cornell.edu/key_workplace/2) [hereinafter DUNLOP COMM’N REPORT] (describing the contentious nature of representation elections and the inadequacy of penalties under the National Labor Relations Act).

13. DEREK C. BOK & JOHN T. DUNLOP, *LABOR AND THE AMERICAN COMMUNITY* app. A at 57 (1970) (citing U.S. Department of Labor, Bureau of Labor Statistics, Directory of National and International Labor Unions in the United States 1967, Bull. No. 1596, 57 (1967)); James B. Atleson, *Law and Union Power: Thoughts on the United States and Canada*, 42 BUFF. L. REV. 463, 465 (1994) (noting that in the U.S., union membership has been in a steady decline since 1955); Bureau of Labor Statistics, Economic News Release, Union Member Summary (Jan. 28, 2009), available at <http://www.bls.gov/news.release/union2.nr0.htm>. See Appendix A, *infra*, to see a graphical representation of the decline of private sector union density.

14. See Lawrence Mishel & Matthew Walters, *How Unions Help All Workers* (EPI Briefing Paper No. 143, Aug. 2003), available at [http://www.epi.org/publications/entry/briefingpapers\\_bp143/](http://www.epi.org/publications/entry/briefingpapers_bp143/) (explaining how collective bargaining within an industry benefits all workers in the same industry, even if they are not members of a collective bargaining unit).

15. See generally Michael C. Harper, *Defining the Economic Relationship Appropriate For Collective Bargaining*, 39 B.C. L. REV. 329, 330–33 (1998) (explaining the compromise between labor and management imposed by the collective bargaining system).

16. 29 U.S.C. §§ 157–158, 163 (2000); see Matthew T. Golden, Comment, *On Replacing the Replacement Worker Doctrine*, 25 COLUM. J.L. & SOC. PROBS. 51, 65 (1991) (describing the special status that strikers maintain while on strike).

17. Golden, *supra* note 16, at 62–65.

signed to ensure that, similarly, during a strike an employer could function at a minimal level and would not be unable to do business at all.<sup>18</sup>

However, from early in the history of the National Labor Relations Act, courts found that, while an employer could not fire an employee for striking, an employer can “permanently replace” striking employees, in which case a returning striker will have to wait until there is turnover in the replacement workforce before he or she can return to work.<sup>19</sup> This legal doctrine was rarely used, however, until the Air Traffic Controllers Strike of 1981 when, in a different legal context, President Ronald Reagan fired striking federal air traffic controllers.<sup>20</sup> This event legitimized the use by private sector employers of permanent replacements, which were used in strikes in a wide range of industries.<sup>21</sup>

In addition, during the Reagan and first Bush administrations the National Labor Relations Board refrained almost entirely from using the powers it did have to address employer interference with workers’ rights under the National Labor Relations Act.<sup>22</sup> This was the period when the National Labor Relations Board ceased almost entirely issuing injunctions to address severe cases of employer coercion or

18. BOK & DUNLOP, *supra* note 13, at 229–35; RICHARD B. FREEMAN & JAMES L. MEDOFF, WHAT DO UNIONS DO? 218–20 (1984); *see also* 93 CONG. REC. 5036, 5038 (1947); 93 CONG. REC. 3521, 3542 (1947).

19. NLRB v. Mackay Radio & Tel. Co., 304 U.S. 333, 345–46 (1938).

20. President Ronald Reagan, Remarks and a Question-And-Answer Session with Reporters on the Air Traffic Controllers Strike (Aug. 3, 1981) (transcript available at <http://www.presidency.ucsb.edu/ws/index.php?pid=44138&st=&st1=>).

21. Stephen F. Befort, *Labor and Employment Law at the Millennium: A Historical Review and Critical Assessment*, 43 B.C. L. REV. 351, 440–41 (2002); James J. Brudney, *To Strike or Not to Strike*, 1999 WIS. L. REV. 65, 71 (reviewing JULIUS GETMAN, THE BETRAYAL OF LOCAL 14: PAPERWORKERS, POLITICS, AND PERMANENT REPLACEMENTS (1998)) (stating that “[s]ince 1980, employers have substantially increased their resort to permanent replacements during economic strikes” and that “a new generation of corporate managers regarded [Reagan’s action] . . . as an invitation to pursue more aggressive responses to lawful strikes”); Jennifer Gordon, *Law, Lawyers and Labor: The United Farm Workers’ Legal Strategy in the 1960s and 1970s and the Role of Law in Union Organizing Today*, 8 U. PA. J. LAB. & EMP. L. 1, 64 (2005) (describing the permanent replacement doctrine and noting that since the Reagan air traffic controller event, “permanent replacement of strikers has become a routine occurrence”); Daniel M. Katz, Louise P. Zandar, & Erica J. Dominitz, *A Commentary on Professor Morris’s Comparison of Discrimination for Union Activity Under the NLRA and RLA*, 3 EMPL. RTS. & EMP. POL’Y J. 305, 311–12 (1999) (discussing President Reagan’s dismissal of the striking federal employees and how “[i]t has now become socially acceptable among many private-sector employers to view unions as akin to weeds, to be rooted out and destroyed”); *see also* Louis Uchitelle, *Ousting Strikers A Costly Tactic*, N.Y. TIMES, Apr. 21, 1992, at D2.

22. C. John Cicero, *TNS, Inc.—The National Labor Relations Board’s Failed Vision of Worker Self-Help to Escape Longterm Health Threats from Workplace Carcinogens and Toxins*, 24 STETSON L. REV. 19, 68 & n.252 (1994) (noting that political considerations influence and shape regulatory policy to reflect the philosophy and values of those in power). Both the Reagan and Bush administrations made pro-management appointments to the NLRB and fostered an anti-worker climate, resulting in Board decisions that were considered “politically motivated exercise[s] in bureaucratic discretion.” *Id.* at 68 n.252; *see also* Posting of Ellen Dannin to Working Life, [http://www.workinglife.org/blogs/view\\_post.php?content\\_id=11524](http://www.workinglife.org/blogs/view_post.php?content_id=11524) (Jan. 27, 2009) (stating that prior to the Reagan administration, decisions by the National Labor Relations Board upheld the legitimacy and value of unions, but Reagan appointed members of the Board to destroy unions and the NLRA, which continued under Bush).

election interference, and in which the delays associated with petitions to hold union representation elections began to lengthen.<sup>23</sup>

The cumulative impact of the weakening of labor law was the gradual diminishment of private sector collective bargaining in U.S. labor markets.<sup>24</sup> While private sector union density had never been over 50% on a national basis, at one time because of high union density in core sectors of the post-war economy like auto, steel, and trucking, collective bargaining agreements set the standard in private sector labor markets as a whole.<sup>25</sup> As the private sector collective bargaining system eroded in the 1980s and 1990s, that standard setting role diminished.

The result was the decoupling of wages and productivity. Just as technology driven productivity began to grow in the 1980s, workers' ability to increase wages in proportion, as predicted by neo-classical economic models, diminished.<sup>26</sup>

But the decoupling of wages and productivity was not the only labor market effect of the decline of collective bargaining. The private sector pension system, which had come into being after World War II, began to decline after 1980, first slowly and then more precipitously in tandem with the decline of the private sector labor movement.<sup>27</sup> As the pension system declined, so did personal savings, and as personal savings declined, the percentage of GDP devoted to current consumption rose.<sup>28</sup>

23. William B. Gould IV, *The NLRB at Age 70: Some Reflections on the Clinton Board and the Bush II Aftermath*, 26 BERKELEY J. EMP. & LAB. L. 309, 316 (2005). "Section 10(j) [of the National Labor Relations Act] allows the Board, in its discretion, to obtain injunctive relief against a wide variety of unfair labor practices." *Id.* "In 1992, under the Bush I Board the number of section 10(j) authorizations had declined to twenty-six, the lowest since the Ford Administration in 1976." *Id.*; see also Andrew Strom, *Rethinking the NLRB's Approach to Union Recognition Agreements*, 15 BERKELEY J. EMP. & LAB. L. 50, 51 n.3 (1994) (noting that in FY 1990, the median length of time between the filing of a representation petition and issuance of a Board decision was 314 days). See generally DUNLOP COMM'N REPORT, *supra* note 12, at 39, 72–73 ("Representation elections should be held before rather than after legal hearings about issues such as the scope of the bargaining unit. The elections should be conducted as promptly as administratively feasible, typically within two weeks.").

24. See Paul Weiler, *Promises to Keep: Securing Workers' Rights to Self-Organization Under the NLRA*, 96 HARV. L. REV. 1769, 1769 (1983) (noting a steady decline in "the fraction of the work force actually engaged in collective bargaining"); see also *id.* at 1771 & n.4 ("Private sector union density declined from over 38% in 1954 to 24% in 1978."). According to Professor Weiler, the perception was that "American labor law . . . failed to make good on its promise to employees that they [were] free to embrace collective bargaining . . ." *Id.* at 1770.

25. See Joel Rogers, *Divide and Conquer: Further "Reflections on the Distinctive Character of American Labor Laws"*, 1990 WIS. L. REV. 1, 105–06 (reporting that within highly unionized industries, collective bargaining standardized wage and benefit levels).

26. *Testimony Before the H. Subcomm. on Labor, Health and Human Services, and Education, Appropriations Comm.*, 110th Cong. (2007) (statement of Lawrence Mishel, President, Economy Policy Institute), available at [http://www.epi.org/content.cfm/webfeatures\\_viewpoints\\_living\\_standards\\_and\\_ed\\_testimony](http://www.epi.org/content.cfm/webfeatures_viewpoints_living_standards_and_ed_testimony); JARED BERNSTEIN & LAWRENCE MISHEL, ECON. POLICY INST., WAGES GAIN GROUND: WORKFORCE BENEFITS IN 1998 FROM TIGHTER LABOR MARKETS, HIGHER MINIMUM WAGE (1999), available at [http://www.epi.org/content.cfm/issuebriefs\\_ib129](http://www.epi.org/content.cfm/issuebriefs_ib129).

27. See generally Patrick W. Seburn, *Evolution of Employer-Provided Defined Benefit Pensions*, MONTHLY LAB. REV., Dec. 1991, at 16 (discussing the history of the U.S. private sector pension system). See Appendix C, *infra*, for a comparison of union density and pension coverage.

28. ALICIA H. MUNNELL ET AL., CTR. FOR RET. RESEARCH AT BOSTON COLL., THE FINANCIAL CRISIS AND PRIVATE DEFINED BENEFIT PLANS 2 (2008), available at [http://ctr.bc.edu/images/stories/Briefs/ib\\_8-18.pdf](http://ctr.bc.edu/images/stories/Briefs/ib_8-18.pdf); Ste-



Despite a more activist National Labor Relations Board in the Clinton Administration, the fundamental weakening of the legal structures protecting collective bargaining that had occurred in the 1970s and 1980s was not reversed.<sup>29</sup> Under the administration of George W. Bush, further weakening of the legal framework protecting collective bargaining occurred, as the National Labor Relations Board and the federal courts took away the protections of the National Labor Relations Act from undocumented workers and from broad groups of workers whose job descriptions included incidental involvement in low level management decisions.<sup>30</sup> At the same time the National Labor Relations Board reverted to the lack of enforcement and delays in enforcement of the labor laws that had been characteristic of the Reagan administration and the administration of George H.W. Bush.<sup>31</sup>

### B. Wage and Hour Laws

While collective bargaining in its heyday covered large sections of the private sector workforce, it was paired in the New Deal labor market regulatory system with a wage and hour regulatory system designed to apply to almost all workers.<sup>32</sup> This

phen F. Befort, *The Perfect Storm of Retirement Insecurity: Fixing the Three-Legged Stool of Social Security, Pensions, and Personal Savings*, 91 MINN. L. REV. 938, 960 (2007) (citing a study by the Bureau of Economic Analysis that reported a precipitous fall in personal savings rate from 10.8% in 1984 to 4.8% in 1994 and 1.8% in 2004); The U.S. economy has become a borrowing economy as “consumer debt grew approximately twice as fast as personal income.” Befort, *supra*, at 960–61 (“[S]avings account credits are giving way to credit card and home equity loan debits.”). For additional raw data see Bureau of Economic Analysis, National Income and Product Accounts Table, Table 1.1.5. Gross Domestic Product, <http://www.bea.gov/national/nipaweb/TableView.aspx?SelectedTable=5&ViewSeries=NO&Java=no&Request3Place=N&3Place=N&FromView=YES&Freq=Year&FirstYear=1947&LastYear=2008&3Place=N&Update=update&JavaBox=no#Mid> (last visited Mar. 1, 2009); BUREAU OF LABOR STATISTICS, 2006 EMPLOYMENT BENEFITS SURVEY, [http://data.bls.gov/PDQ/servlet/SurveyOutputServlet;jsessionid=f030f7148daeKS09\\$3FS](http://data.bls.gov/PDQ/servlet/SurveyOutputServlet;jsessionid=f030f7148daeKS09$3FS) (last visited Mar. 1, 2009).

29. Wilma B. Liebman, *Decline and Disenchantment: Reflections on the Aging of the National Labor Relations Board*, 28 BERKELEY J. EMP. & LAB. L. 569, 580–82 (2008) (noting that “many of the key decisions issued by the . . . Clinton Board, which had endeavored to update the law by affording greater protections to workers in an evolving economy,” were quickly overruled by courts or the Bush Board).

30. Hoffman Plastic Compounds v. NLRB, 535 U.S. 137, 151–52 (2002) (holding that undocumented workers are not entitled to back-pay awards under the NLRA); NLRB v. Ky. River Cmty. Care, Inc., 532 U.S. 706, 713, 722 (2001) (holding that nurses who exercise professional judgment while caring for patients are not protected by the NLRA). For NLRB’s interpretation of *Kentucky River Community Care*, see *Croft Metals, Inc.*, 348 N.L.R.B. 717, 721 (2006), *Golden Crest Healthcare Center*, 348 N.L.R.B. 727, 728–31 (2006), and *Oakwood Healthcare, Inc.*, 348 N.L.R.B. 686, 686 (2006).

31. See LANCE COMPA, UNFAIR ADVANTAGE: WORKERS’ FREEDOM OF ASSOCIATION IN THE UNITED STATES UNDER INTERNATIONAL HUMAN RIGHTS STANDARDS 91–92 (2000), available at <http://www.hrw.org/en/reports/2000/08/01/unfair-advantage-workers-freedom-association-united-states-under-international-hu> (discussing several examples of studies documenting the increase in workers’ rights violations in the 1970s and 1980s, and noting that a 1994 report “documented one hundred recent cases of flagrant workers’ rights violations by employers and the failure of U.S. labor law enforcement authorities to remedy the violations”). See generally, Liebman, *supra* note 29; AFL-CIO, THE SILENT WAR: THE ASSAULT ON WORKERS’ FREEDOM TO CHOOSE A UNION AND BARGAIN COLLECTIVELY IN THE UNITED STATES (2005), available at [http://www.aflcio.org/joinunion/how/upload/vatw\\_issuebrief.pdf](http://www.aflcio.org/joinunion/how/upload/vatw_issuebrief.pdf).

32. Fair Labor Standards Act, Pub. L. No. 75-718, 52 Stat. 1060 (1938) (codified as amended at 29 U.S.C. §§ 201–219 (1988)) (requiring, *inter alia*, that employers must pay their employees no less than the statutory minimum wage and time-and-a-half compensation for overtime); Marion G. Crain, *Afterword: The American*

system's purpose was to establish a labor market floor both to protect the poorest workers whom the minimum wage would apply to, and to create a context that would enhance the bargaining power of workers throughout the economy.<sup>33</sup>

However, as in the case of the collective bargaining system, starting in 1980 the wage and hour regime was weakened.<sup>34</sup> This was done in two simple ways. First, the minimum wage was allowed to stagnate during periods of significant inflation and for years thereafter.<sup>35</sup> While raising the minimum wage has been a staple political fight for Democratic politicians for decades, the result has nonetheless been minimum wage levels that have not kept pace with inflation.<sup>36</sup>

Both the minimum wage and the rules governing the forty hour work week are enforced primarily by the federal Department of Labor, though the states may impose higher minimum wage laws and may engage in their own enforcement activity.<sup>37</sup>

In 1980, the Department of Labor budget was \$29,724,002,000 (\$77,665,859,241 [2008 dollars]), representing 1.07% of GDP and \$277.95 (\$726.26 [2008 dollars]) per member of the workforce.<sup>38</sup> In 2000 the Department of Labor budget was

*Romance with Autonomy*, 10 EMP. RTS. & EMP. POL'Y J. 187, 190 n.6 (2006) ("The New Deal policies of the mid-1900s were designed to reduce wage competition so that American workers would enjoy higher wages and more secure employment, increasing consumption and stimulating business growth. The core of the New Deal was the commitment to labor unionism as a vehicle for worker representation and collective bargaining as a means to establish the terms of employment at the industry and local level. The labor laws . . . shored up the rights of nonunion workers and simultaneously provided a minimum threshold from which unions might bargain." (internal citations omitted)).

33. See Crain, *supra* note 32, at 190 n.6.

34. See Daniel Gross, *Income Inequality*, *Writ Larger*, N.Y. TIMES, June 10, 2007, § 3, at 7 (reporting that weakened unions, cuts in marginal income tax rates, and the inability of minimum wage to keep pace with inflation reduced workers' bargaining power); see also Robert Pear, *Clinton Will Seek Spending to Curb Aliens, Aides Say*, N.Y. TIMES, Jan. 22, 1995, § 1, at 1 (reporting that the Clinton administration intended to reverse a decline in enforcement of wage and hour laws under prior administrations).

35. See Brett Theodos & Robert Bednarzik, *Earnings Mobility and Low-Wage Workers in the United States*, MONTHLY LAB. REV., July 2006, at 34, 34, 35 (noting that while corporate profits and real average wages have increased with productivity since 1990, minimum wage remained virtually unchanged).

36. Liana Fox, *Minimum Wage Increasingly Lags Poverty Line*, ECON. POL'Y INST., Jan. 31, 2007, [http://www.epi.org/economic\\_snapshots/entry/webfeatures\\_snapshots\\_20070131/](http://www.epi.org/economic_snapshots/entry/webfeatures_snapshots_20070131/) ("The minimum wage is at its lowest real value in over 50 years. . . . As the basic income required to support a family has grown with inflation, the minimum wage has not kept pace with the rising costs of goods." (footnote omitted)); LAWRENCE MISHEL, ET AL., *THE STATE OF WORKING AMERICA 2008/2009*, fig.3AA (forthcoming Mar. 2009), available at [http://www.stateofworkingamerica.org/tabfig/2008/03/SWA08\\_Wages\\_Figure.3AA.pdf](http://www.stateofworkingamerica.org/tabfig/2008/03/SWA08_Wages_Figure.3AA.pdf); see Frank W. Munger, *Social Citizen as "Guest Worker": A Comment on Identities of Immigrants and the Working Poor*, 49 N.Y.L. SCH. L. REV. 665, 668 (2004) (noting that minimum wage has not kept up with inflation since the mid-1970s); see also Robert J. Gordon & Ian Dew-Becker, *Controversies About the Rise of American Inequality: A Survey* 16 (Nat'l Bureau of Econ. Research, Working Paper No. 13982, 2008), available at [http://www.nber.org/papers/w13982.pdf?new\\_window=1](http://www.nber.org/papers/w13982.pdf?new_window=1). See Appendix E, *infra*, for real dollar value of the minimum wage since 1960.

37. Fair Labor Standards Act of 1938 § 18, 29 U.S.C. § 218 (2006); see Theodos & Bednarzik, *supra* note 35, at 35 ("To date, 18 States and the District of Columbia have established minimum wages above the federally mandated level.").

38. The United States Budget for Fiscal Year 1982, at 476, available at <http://fraser.stlouisfed.org/publications/usbudget/page/11386/2558/download/11386.pdf>; Authors' calculations made assuming a \$2.7895 trillion GDP and a total civilian labor force of 106,940,000. See BUREAU OF ECONOMIC ANALYSIS, NATIONAL INCOME

## THE LEGACY OF DEREGULATION AND THE FINANCIAL CRISIS

\$31,354,100,000 (\$39,202,275,227 [2008 dollars]), representing .32% of GDP and \$219.90 (\$274.94 [2008 dollars]) per member of the workforce.<sup>39</sup> In 2008 the Department of Labor budget authority was \$50,400,000,000, representing .35% of GDP and \$326.66 per member of the workforce.<sup>40</sup> This represents a nominal increase in per-workforce-member spending. However, adjusting for inflation reveals a 35% decrease in the Department of Labor Budget and a 55% decrease in per-workforce-member spending between 1980 and 2008.<sup>41</sup>

In 1980, the Department of Labor's Wage and Hour Division employed 1046 investigators.<sup>42</sup> In 2000, at the end of the Clinton administration, the Wage and Hour Division's budget was \$147.2 million and the Division employed 949 investigators.<sup>43</sup> Finally, in 2008, the budget was \$187.1 million and the Department employed 750 investigators.<sup>44</sup> During this period, the workforce grew from less than 107 million to over 154 million people.<sup>45</sup> As a result, even after eight years of the Clinton administration, the enforcement capacity never even approached the levels of the 1970s.<sup>46</sup>

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AND PRODUCT ACCOUNTS TABLE: TABLE 1.1.5. GROSS DOMESTIC PRODUCT (2009), <http://www.bea.gov/national/nipaweb/TableView.aspx?SelectedTable=5&ViewSeries=NO&Java=no&Request3Place=N&3Place=N&FromView=YES&Freq=Y&Year&FirstYear=1979&LastYear=2008&3Place=N&Update=Update&JavaBox=no#Mid>; *Household Data Annual Averages*, EMP. & EARNINGS (Bureau of Labor Statistics, Wash., D.C.) Jan. 2009, at 193–94, available at <http://www.bls.gov/cps/cpsaat1.pdf>.

39. United States Department of Labor Budget Overview, Fiscal Year 2002, available at [http://www.dol.gov/\\_sec/Budget2002/budgetfy2002\\_txt.htm](http://www.dol.gov/_sec/Budget2002/budgetfy2002_txt.htm). Authors' calculations made assuming a \$9.817 trillion GDP and a total civilian labor force of 142,583,000. See BUREAU OF ECONOMIC ANALYSIS, *supra* note 38; *Household Data Annual Averages*, *supra* note 38, at 193–94.

40. United States Department of Labor Budget Overview, Fiscal Year 2008, available at [https://www.dol.gov/\\_sec/Budget2008/overview.htm](https://www.dol.gov/_sec/Budget2008/overview.htm); Authors' calculations made assuming a \$14.2646 trillion GDP and a total civilian labor force of 154,287,000. See BUREAU OF ECONOMIC ANALYSIS, *supra* note 38; *Household Data Annual Averages*, *supra* note 38, at 193–94.

41. Inflation adjustment calculated by authors, using Bureau of Labor Statistics Consumer Price Index Inflation Calculator Formula, <http://data.bls.gov/cgi-bin/cpicalc.pl>.

42. BUDGET OF THE U.S. GOV'T, BUDGET AUTHORITY AND OUTLAYS BY AGENCY (1982); David J. Walsh, *The FLSA Comp Time Controversy: Fostering Flexibility or Diminishing Worker Rights?*, 20 BERKELEY J. EMP. & LAB. L. 74, 106 n.147 (1999).

43. U.S. DEP'T OF LABOR, EMPLOYMENT STANDARDS ADMIN., WAGE AND HOUR DIVISION, 1999–2000 REPORT ON INITIATIVES 3 (2000), available at [http://nelp.3cdn.net/a5c00e8d7415a905dd\\_o4m6ikkkt.pdf](http://nelp.3cdn.net/a5c00e8d7415a905dd_o4m6ikkkt.pdf); U.S. Dep't of Labor, Employment Standards Administration: Overview, [http://www.dol.gov/\\_sec/budget/esa20001.htm#content](http://www.dol.gov/_sec/budget/esa20001.htm#content) (last visited Feb. 26, 2009) (indicating that in FY 2000, the Wage and Hour Division made a budget request for \$147.2 million).

44. UNITED STATES DEP'T OF LABOR, FISCAL YEAR 2008 BUDGET OVERVIEW, [https://www.dol.gov/\\_sec/Budget2008/overview.htm#esa](https://www.dol.gov/_sec/Budget2008/overview.htm#esa) (last visited Mar. 5, 2009) (reporting that the Wage and Hour Division's budget request for FY 2008 was \$187.1 million, with 1,336 full-time employees or FTE); *Is the Department of Labor Effectively Enforcing Our Wage and Hour Laws?: Hearing Before the H. Comm. on Education & Labor*, 110th Cong. 5 (2008) (testimony of Kim Bobo), available at <http://edlabor.house.gov/testimony/2008-07-15-KimBobo.pdf>.

45. *Household Data Annual Averages*, *supra* note 38, at 193–94.

46. Edward Montgomery, *Department of Labor: Promoting Opportunity While Protecting Worker Rights*, in CHANGE FOR AMERICA: A PROGRESSIVE BLUEPRINT FOR THE 44TH PRESIDENT 178–79 (Mark Green & Michele Jolin eds., 2008).

One significant force counterbalancing the weakening of administrative enforcement of wage and hour rules was the growing level of private enforcement of the Fair Labor Standards Act and its state law equivalents, particularly around overtime rules.<sup>47</sup> The growth in these cases began in the early 1990s with the Nordstrom overtime cases, and proliferated particularly in the retail sector in the 1990s.<sup>48</sup> Wal-Mart has been the defendant in a number of these cases.<sup>49</sup> These cases generally center on the refusal of employers to consider incidental worktime such as time to change into mandatory uniforms as worktime.<sup>50</sup> However, the economics of this type of litigation has tended to confine it to large workforces.<sup>51</sup> It is less clear that this type of litigation has been broadly effective in enforcing the wage and hour laws in the large parts of the economy characterized by small firms such as construction and restaurants.<sup>52</sup>

A further development that has weakened both the wage and hour regulatory system and the collective bargaining system has been the growth in employment relationships that employers have succeeded in classifying as independent contrac-

47. See Catherine K. Ruckelshaus, *Labor's Wage War*, 35 *FORDHAM URB. L.J.* 373, 385–86 (2008).

48. Isadore Barmash, *Unusual Setbacks For Nordstrom*, *N.Y. TIMES*, Mar. 27, 1990, at D12, available at <http://query.nytimes.com/gst/fullpage.html?res=9C0CE6DF1731F934A15750C0A966958260>; *Nordstrom Set to Resolve Suit*, *N.Y. TIMES*, Jan. 12, 1993, at D2, available at <http://query.nytimes.com/gst/fullpage.html?res=9F0CE2D6133EF931A25752C0A965958260>; *Settlement Approved in Nordstrom Back Pay Lawsuit*, *N.Y. TIMES*, Apr. 13, 1993, at D4, available at <http://query.nytimes.com/gst/fullpage.html?res=9F0CE3DA163BF930A25752C0A965958260>. For a discussion of this trend, see Ruckelshaus, *supra* note 47.

49. See, e.g., *Thiebes v. Wal-Mart Stores, Inc.*, 220 Fed. App'x 750 (9th Cir. 2007); *In re Wal-Mart Stores, Inc.*, 395 F.3d 1177 (10th Cir. 2005); *In re Wage Payment Litig.*, 759 A.2d 217 (Me. 2000); *Lopez v. Wal-Mart Stores, Inc.*, 111 F. Supp. 2d 865 (S.D. Tex. 2000); *Yates v. Wal-Mart Stores, Inc.*, 58 F. Supp. 2d 1217 (D. Colo. 1999); *Basinger v. Wal-Mart Stores, Inc.*, 1999 U.S. Dist. LEXIS 22167 (D. Me. 1999). In 2008, Wal-Mart announced the settlement of 63 wage and hour class action lawsuits that were pending in federal and state courts in 42 states for approximately \$640 million. See Press Release, Wal-Mart, Wal-Mart and Plaintiffs' Counsel Announce Settlement of Most Wage and Hour Class Action Lawsuits Against the Company (Dec. 23, 2008) (available at <http://walmartstores.com/FactsNews/NewsRoom/8867.aspx>).

50. See *IBP, Inc. v. Alvarez*, 546 U.S. 21 (2005). In *IBP*, a class of poultry plant employees alleged that the time spent changing in and out of protective clothing on the employer's premises was compensable time under the FLSA. *Id.* at 24. *IBP*, a large producer of beef and pork products, required all workers to don protective garments prior to each shift and expected workers to clock out before they "doffed" or removed the garments at the end of each shift. *Id.* at 30–31. The Supreme Court determined that the protective clothing was "integral and indispensable" to a "principal activity" of the employees' work, thus time spent donning and doffing the protective clothing was covered by the FLSA. *Id.* at 37.

51. Most wage and hour law claims are uneconomic for plaintiffs to pursue individually because the costs of litigation greatly exceed the potential recovery. See *Phillips Petroleum Co. v. Shutts*, 472 U.S. 797, 809 (1985) (discussing how class action litigation permits "plaintiffs to pool claims which would be uneconomical to litigate individually").

52. "The restaurant industry employs an estimated 13 million people, or 9% of the U.S. workforce." NATIONAL RESTAURANT ASSOCIATION, 2009 RESTAURANT INDUSTRY POCKET FACTBOOK (2009), available at <http://www.restaurant.org/pdfs/research/2009Factbook.pdf>; see also Ruckelshaus, *supra* note 47, at 387 (noting that "the actual amounts recovered in low-wage cases are often insufficient to tempt private attorneys to undertake the case" because an "individual worker would have to continue to make periodic fee payments, pay for discovery, preliminary discovery motions, and any substantive legal motions filed by either side"). However, bringing a class action lawsuit may be difficult for employees of small firms because such lawsuits require that "membership of the class be so numerous as to make it impracticable for the plaintiff to bring all before the court." *Matthies v. Seymour Mfg. Co.*, 270 F.2d 365, 370 (2d Cir. 1959); *FED. R. CIV. P.* 23(a)(1).

tor relationships.<sup>53</sup> These types of relationships have become prevalent in areas of the economy as diverse and significant as home health care, software development, and trucking.<sup>54</sup> The growth of independent contractor arrangements that actually have the economic and sociological content of a conventional employer-employee relationship is difficult to tease out of statistics regarding the growth of self-employment, but this phenomenon is clearly a contributor to the erosion of labor market regulation.<sup>55</sup>

### C. *The Decline of the Progressive Tax System*

Tax policy as a broad subject matter is often omitted in discussions of labor market regulation.<sup>56</sup> However, tax policy is relevant to our discussion in several ways. First,

53. See Ruckelshaus, *supra* note 47, at 378, 380–83 (“In independent contractor schemes, firms argue they are off-the-hook for any violations of rules protecting ‘employees.’”). The GAO estimates that 10.3 million independent contractors were employed in 2005, and “the number of independent contractors in the total employed workforce grew from 6.7 percent in 1995 to 7.4 percent in 2005.” *Employee Misclassification: Improved Outreach Could Help Ensure Proper Worker Classification Before the Subcomm. on Income Security and Family Support and Subcomm. on Select Revenue Measure of the H. Comm. on Ways and Means, 110th Cong. 2* (2007) (statement of Sigurd R. Nilsen, Director Education, Workforce, and Income Security), available at <http://www.gao.gov/new.items/d07859t.pdf>.

54. Lawsuits often involve independent contractors working within those very areas of the economy. See, e.g., *Vizcaino v. Microsoft Corp.*, 97 F.3d 1187, 1196 (9th Cir. 1996) (concluding that Microsoft misclassified employees as “independent contractors” to deny them company pension benefits), *rev’d on other grounds*, 120 F.3d 1006 (9th Cir. 1997); *Bonnette v. Cal. Health & Welfare Agency*, 704 F.2d 1465, 1470 (9th Cir. 1983) (concluding that the State of California paid “chore workers” under California’s in-home supportive services program less than the federal minimum wage in violation of the FLSA); Steven Greenhouse, *Teamsters Hope to Lure FedEx Drivers*, N.Y. TIMES, May 30, 2006, at A12 (discussing FedEx’s efforts to prevent truck drivers classified as “independent contractors” from unionizing); see also Ruckelshaus, *supra* note 47, at 381–82 (“Independent contractor misclassification occurs with an alarming frequency in construction, day labor, janitorial and building services, home health care, child care, agriculture, poultry and meat processing, high-tech, delivery, trucking, home-based work, and the public sectors.” (footnotes omitted)).

55. The growth of independent contractor arrangements has enabled employers to opt out of core labor market regulation by misclassifying employees as independent contractors. See Ruckelshaus, *supra* note 47, at 373, 374–75, 381. See generally Mark H. Grunewald, *Introduction*, 52 WASH. & LEE L. REV. 725, 727 (1995) (discussing the growth of contingent employment in the job market and the need for proper classification of independent contractors). When employers misclassify employees as independent contractors, employees are excluded from coverage from key state and federal laws designed to protect workers such as: minimum wage and overtime premium pay, family and medical leave, unemployment insurance, workers’ compensation, Social Security, and Medicare. See Ruckelshaus, *supra* note 47, at 381. Moreover, misclassification of employees as independent contractors has negatively affected the administration of state worker compensation and unemployment insurance programs. See FISCAL POLICY INST., NEW YORK STATE WORKERS’ COMPENSATION: HOW BIG IS THE COVERAGE SHORTFALL? 2 (2007), available at [http://www.fiscalpolicy.org/publications2007/FPI\\_WorkersCompShortfall\\_WithAddendum.pdf](http://www.fiscalpolicy.org/publications2007/FPI_WorkersCompShortfall_WithAddendum.pdf) (estimating that misclassification of workers amounts to a loss of \$500 million to \$1 billion annually in evaded workers’ compensation premium); MICHAEL P. KELSAY ET AL., THE ECONOMIC COSTS OF EMPLOYEE MISCLASSIFICATION IN THE STATE OF ILLINOIS 6, 7 (2006), available at [http://www.faircontracting.org/NAFCnewsite/prevalingwage/pdf/Illinois\\_Misclassification\\_Study.pdf](http://www.faircontracting.org/NAFCnewsite/prevalingwage/pdf/Illinois_Misclassification_Study.pdf) (estimating that misclassification of workers in 2005 resulted in a \$53.7 million loss of unemployment insurance taxes and misclassification of workers in 2004 amounted to a \$97.9 million loss in workers’ compensation premiums).

56. See Anne L. Alstott, *Tax Policy and Feminism: Competing Goals and Institutional Choices*, 96 COLUM. L. REV. 2001, 2076 (1996) (noting that tax policy played no role in the Family and Medical Leave Act).

the dismantling of progressive tax structures since the 1970s has weakened the ability of the United States to fund the types of public goods that can drive sustained productivity increases—i.e. improved public schools, high speed internet, and a modernized, energy efficient transportation infrastructure.<sup>57</sup> In the absence of these investments, asset bubbles appear to be an alternative approach to sustaining rising living standards.<sup>58</sup>

Second, the declining progressivity in the tax structure has meant that the tax structure plays less of a role in seriously counteracting economic inequality.<sup>59</sup> In the late 1950s, peak marginal tax rates were over 90%.<sup>60</sup> By 1992, those rates, while slightly higher than they had fallen to at the end of the Reagan administration, remained at low levels compared to the historic post-war rates.<sup>61</sup> Of course, the Clinton administration raised tax rates across the board, and increased progressiv-

57. Marjorie E. Kornhauser, *The Rhetoric of the Anti-Progressive Income Tax Movement: A Typical Male Reaction*, 86 MICH. L. REV. 465, 465, 471–72 (1987). A progressive tax structure is one that imposes higher tax liability based on a family's level of income. Donna M. Byrne, *Progressive Taxation Revisited*, 37 ARIZ. L. REV. 739, 742 (1995). Thus, high income taxpayers pay a higher percentage of their income in taxes than lower income taxpayers. *Id.* "The economic and political consensus about progressive [taxes] began to fall apart sometime in the 1970s." Kornhauser, *supra*, at 465–66. In contrast, other tax scholars argue that progressive income taxes are beneficial to society because the federal government can raise revenues by imposing a higher tax rate for the top 1% of income earners. See Martin J. McMahon, Jr., *The Matthew Effect and Federal Taxation*, 45 B.C. L. REV. 993, 998–1012 (2004) (arguing that the existing progressive income tax system is unfair because it taxes the "super-rich" too lightly relative to everyone else); James R. Repetti, *Introduction to the State of Federal Income Taxation: Rates, Progressivity, and Budget Processes*, 45 B.C. L. REV. 989, 991 (2004) (discussing psychological studies that "support the view that income has declining marginal utility and, therefore, the redistribution of income from the rich to the poor can increase total welfare in a society").

58. Frederic S. Mishkin of the Board of Governors of the Federal Reserve has described asset bubbles as follows:

Financial history reveals the following typical chain of events: Because of either exuberant expectations about economic prospects or structural changes in financial markets, a credit boom begins, increasing the demand for some assets and thereby raising their prices. The rise in asset values, in turn, encourages further lending against these assets, increasing demand, and hence their prices, even more. This feedback loop can generate a bubble, and the bubble can cause credit standards to ease as lenders become less concerned about the ability of the borrowers to repay loans and instead rely on further appreciation of the asset to shield themselves from losses.

Frederic S. Mishkin, Member of the Bd. of Governors of the Fed. Reserve, Address at the Wharton Financial Institutes Center and Oliver Wyman Institute's Annual Financial Risk Roundtable: How Should We Respond to Asset Price Bubbles? (May 15, 2008) (transcript available at <http://www.federalreserve.gov/newsevents/speech/mishkin20080515a.htm>).

59. McMahon, *supra* note 57, at 1023–23.

60. See Internal Revenue Code of 1954, Pub. L. No. 83-591, 68A Stat. 3; see also Daniel L. Simmons, *Is it Really Reform? A Theoretical Overview of the 1986 Tax Reform Act*, 1987 B.Y.U. L. REV. 151, 155–56 (summarizing that the Internal Revenue Code of 1954 carried a range of marginal tax rates from 21% at the bottom to 91% at the top, meaning that individuals in the top 91% income bracket had to pay 91 cents of every taxable dollar to the U.S. Treasury).

61. Compare I.R.C. § 1(a) (1954) (setting the highest marginal tax rate on individual income at 91%), and Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986) (passed by the Reagan administration and setting the highest marginal tax rate on individuals at 28%), with Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388-403 (1990) (passed by the George H.W. Bush administration and raising the highest marginal tax rate on individual income at 31% by replacing the fuel taxes with 10% surtax on the top income bracket).

ity modestly, but they left the highest rate below 40%.<sup>62</sup> Then, President George W. Bush made rolling back the Clinton era tax rates a key policy goal for his first year in office, one that he achieved.<sup>63</sup>

For most of the last one hundred years, capital gains tax rates have been lower than the top income tax rate, creating significant tax subsidies for the wealthy whose incomes tend to be more weighted toward capital gains.<sup>64</sup> The Bush administration took this to new extremes by lowering the long-term capital gains tax rate to 15%, a rate less than that paid by even the poorest Americans, when taking social security taxes and Medicare taxes into account.<sup>65</sup> This set the stage for manipulative conduct such as the characterization of hedge fund and private equity incentive fees (often referred to as “carried interest”) as capital gains, allowing some of the wealthiest people in the United States to pay outrageously low taxes on large amounts of income compared to ordinary income tax rates paid by middle income Americans.<sup>66</sup>

62. See Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 416 (1993) (raising the marginal tax rate from 36% to 39.6% for individuals earning incomes above \$125,000).

63. See Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38 (2001) (providing reductions in income tax rates for individuals, significant changes to the federal estate tax, and modified pension and individual retirement arrangement provisions).

64. Historically, the maximum individual tax rate has exceeded the maximum capital gains tax rate. See CITIZENS FOR TAX JUSTICE, FEDERAL INCOME TAX TREATMENT OF CAPITAL GAINS AND REGULAR INCOME: HISTORICAL DATA (2004), available at <http://www.ctj.org/pdf/regcg.pdf>. With the Tax Reform Act of 1986, Congress reversed this long-standing government tax policy by lowering the maximum capital gains tax rate to a level of parity with the maximum income tax rate. See John W. Lee, III, *The Capital Gains “Sieve” and the “Farce” of Progressivity 1921–1986*, 1 HASTINGS BUS. L.J. 1, 6 (2005) (noting that the Tax Reform Act of 1986, set both the maximum individual income rate and capital gains tax rates at 28%).

65. See Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, 117 Stat. 752, 758 (2003) (reducing the maximum capital gains tax rate from 20% to 15% and the minimum capital gains from 10% to 5%); Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38, 42 (2001) (providing for significant reductions in income tax rates from the top rate of 39.1% in 2001 to an eventual level of 35% in 2006 and thereafter). See generally William G. Gale & Peter R. Orszag, *An Economic Assessment of Tax Policy in the Bush Administration, 2001–2004*, 45 B.C. L. REV. 1157 (2004) (concluding that the Bush administration’s 2001 and 2003 tax cuts were regressive, unaffordable, and poorly designed to boost economic growth).

66. Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1, 3–4 (2008). Current tax law enables hedge fund and private equity managers who receive the industry standard “two and twenty” (a 2% management fee and 20% profits interest) to defer tax on income derived from their labor services by converting the income into long-term capital gains. *Id.* This quirk in the tax law has allowed fund managers, some of the richest workers in the country, to pay tax on their labor income at lower capital gains tax rates instead of higher ordinary income rates. *Id.* The use of “carried interests” as part of a compensation strategy for fund managers has ignited a heated debate that has prompted the introduction of legislation that would boost taxes on publicly traded financial partnerships. Randall Dodd, *Tax Breaks for Billionaires: Loophole for Hedge Fund Managers Costs Billions in Tax Revenue*, ECON. POL’Y INST., July 24, 2007, <http://www.epi.org/publications/entry/pm120/>. See generally DAVID CAY JOHNSTON, PERFECTLY LEGAL: THE COVERT CAMPAIGN TO RIG OUR TAX SYSTEM TO BENEFIT THE SUPER RICH – AND CHEAT EVERYBODY ELSE (2003). On one side of the debate are “tax scholars, former policymakers, legislators, and . . . business executives [that] argue[ ] that carried interest is, in substance, compensation for labor and should be taxed as such.” See Note, *Taxing Private Equity Carried Interest Using an Incentive Stock Option Analogy*, 121 HARV. L. REV. 846, 846–47 (2008). This group, in essence, advocates for tax law reforms that would raise taxes on carried interest. *Id.* On the other side of the debate, private equity partners and those who represent them, argue that tax law

D. *Consequences: Stagnant Real Wages, Rising Inequality, Falling Savings Rates*

While proving causal connections between legal developments and economic outcomes is treacherous, the weakening of labor market regulation over the past 30 years has been associated in time with labor market outcomes that set the stage for the financial crisis. The past thirty years has been a period of stagnant real wages, with the attendant consequence that increases in household consumption have had to be based on either more intensive participation in labor markets by household members, lower taxes or lower savings, or all three.<sup>67</sup>

Not surprisingly, stagnant wages have been associated with rising income and asset inequality, in particular when combined with the extraordinarily regressive tax policies of the George W. Bush administration.<sup>68</sup>

However, less well known or understood is the decline in benefit plan coverage that particularly results from a weakening labor movement.<sup>69</sup> Real pension plans are an outgrowth of a strong collective bargaining system.<sup>70</sup> They are collective

reforms would create inequity, discourage investors, or otherwise harm the economy. *Id.* at 847. Thus far, no politically viable resolution of the issue has yet emerged. See generally Howard E. Abrams, *Taxation of Carried Interests: The Reform That Did Not Happen*, 40 *LOV. U. CHI. L.J.* 197, 210–14 (2009) (discussing failed legislative attempts to revise the term “investment services partnership interest” of § 710 to the Internal Revenue Code to treat “carried interests” as compensation income).

67. See COUNCIL OF ECON. ADVISERS, *ECONOMIC REPORT OF THE PRESIDENT 24* (2007), available at [http://www.gpoaccess.gov/eop/2007/2007\\_erp.pdf](http://www.gpoaccess.gov/eop/2007/2007_erp.pdf) (discussing how rising energy costs, rising wealth, and falling unemployment rates caused the personal saving rate to fall to negative 1% in 2006—“its lowest annual level during the post-World War II era”). See Appendix B, *infra*, for a comparison of real wages and worker productivity.

68. See JARED BERNSTEIN ET AL., *CTR. ON BUDGET & POL’Y PRIORITIES, PULLING APART: A STATE-BY-STATE ANALYSIS OF INCOME TRENDS 3* (2008), <http://www.cbpp.org/4-9-08sfp.pdf> (noting that since the late 1980s, income inequality has grown significantly due to stagnant wages for bottom and middle wage earners); see also McMahon, *supra* note 57, at 998–99. See Appendix F, *infra*, for illustration of the growth in inequality.

69. See Craig C. Martin & Joshua Rafsky, *The Pension Protection Act of 2006: An Overview of Sweeping Changes in the Law Governing Retirement Plans*, 40 *J. MARSHALL L. REV.* 843, 847–50 (2007) (attributing the decline of large unionized companies that sponsor pension plans to several factors including: (1) high administration costs and heavy regulatory burdens, (2) employers’ desire to eliminate the investment risks associated with retirement plans, (3) the nation’s shift from a manufacturing-based economy to a serviced-based economy, and (4) increased international and domestic competition in traditional industries sponsoring pension plans); Stephen Taub, *Pension Plans Disappearing*, *CFO.COM*, June 27, 2006, <http://www.cfo.com/article.cfm/7108045> (noting that defined benefit pension plans offered by Fortune 1000 companies are “disappearing at an increasing pace”); *Private Pension Plans, Participation, and Assets: Update*, *EMP. BENEFIT RES. INST.*, Jan. 2003, <http://www.ebri.org/publications/facts/index.cfm?fa=0103fact> (“The total number of private defined benefit plans increased from 103,346 in 1975 to 175,143 in 1983. . . . After 1986, the number of defined benefit plans steadily declined, to 56,405 in 1998.”).

70. In the 1920s the American Federation of Labor founded its own insurance company, the Union Labor Life Insurance Company, and in 1929 the International Brotherhood of Electrical Workers established the first multiemployer benefit plan. ULLICO, Inc., *About Us*, <http://www.ullico.com/b/txt.cfm?page=Abo-Aboutus> (last visited Apr. 1, 2009); see also TERESA GHILARDUCCI, *WHEN I’M SIXTY-FOUR: THE PLOT AGAINST PENSIONS AND THE PLAN TO SAVE THEM* 240–41 (2008); Martin & Rafsky, *supra* note 69, at 848.



savings and insurance instruments.<sup>71</sup> And as collective bargaining has declined as a structure for labor relations, pension coverage has declined with it.<sup>72</sup>

Finally, of course, all these developments combined to cause a steady, and ultimately quite significant increase in consumer spending as a percentage of GDP.<sup>73</sup> This increase has been fed by unregulated consumer credit, provided through increasingly opaque capital market structures.<sup>74</sup> Both developments are discussed in the next two sections of this paper. This section has shown how labor market deregulation contributed to an environment of stagnating wages and endangered benefits where policymakers in both parties were interested in finding ways to prop up consumer spending in what was fast becoming a low wage economy.<sup>75</sup>

## II. DEREGULATION OF THE RESIDENTIAL MORTGAGE MARKETS

### A. History of U.S. Mortgage Regulation

Congress passed a series of emergency acts in the early 1930s intended to prevent the banking crisis from doing unnecessary damage to the nation's financial infrastructure and spreading further into the real economy.<sup>76</sup> Simultaneously, the federal government began the longer process of regulating the banking, securities and

71. See Martin & Rafsky, *supra* note 69, at 845 (“Pension plans are retirement savings programs provided by employers to employees.”). A traditional defined benefit plan promises retired employees periodic payments “for the duration of the retiree’s life.” *Id.* The assets of a pension plan “are accumulated through employer contributions and profit from investment of the plan’s assets.” *Id.*

72. Harry Arthurs, *Reconciling Differences Differently: Reflections on Labor Law and Worker Voice After Collective Bargaining*, 28 COMP. LAB. L. & POL’Y J. 155, 161 (2007) (concluding that the decline of collective bargaining agreements likely aided in the decline in pensions); Martin & Rafsky, *supra* note 69, at 848.

73. In 1979, consumer spending accounted for 62% of the U.S. Gross Domestic Product; today, consumer spending accounts for over 70% of GDP. BUREAU OF ECONOMIC ANALYSIS, NATIONAL INCOME AND PRODUCT ACCOUNTS TABLE: TABLE 1.1.5. GROSS DOMESTIC PRODUCT (2009), <http://www.bea.gov/national/nipaweb/TableView.asp?SelectedTable=5&ViewSeries=no&Java=no&Request3Place=n&3Place=n&FromView=YES&Freq=Year&FirstYear=1979&LastYear=2008&3Place=N&Update=Update&JavaBox=no#Mid>. See Appendix D, *infra*, for a comparison of consumer spending and union density.

74. See generally Ralph Brubaker & Kenneth N. Klee, *Resolved: The 1978 Bankruptcy Code Has Been a Success*, 12 AM. BANKR. INST. L. REV. 273, 286 (2004) (explaining that the American economy is “dependent upon robust consumer spending that’s increasingly fueled by largely unregulated consumer credit”); Programs, *Federal Pre-emption of State Usury Laws*, 37 BUS. LAW. 747, 780 (1982) (arguing that consumers who “do not understand the full ‘cost’ of the credit they are buying . . . will buy more credit than they truly want” and that “more consumer credit [is] sold in an unregulated, imperfect market than people want”).

75. See generally Scott D. Miller, *Revitalizing the FSLA*, 19 HOFSTRA LAB. & EMP. L.J. 1, 59–60, 72, 88 (2001) (describing how numerous factors including “weakened unions[ ] and industrial deregulation” mean that improving a “climate of job insecurity, job instability, or stagnate wages” will be slow; how “unraveling [of the social compact] since the late 1970s” has decreased wages and benefits for workers; and how Americans are fixated with consumer spending).

76. The Reconstruction Finance Corporation Act of 1932 (RFCA) provided loans to financial institutions as well as railroads, many of which were struggling to repay their creditors. See Reconstruction Finance Corporation Act of 1932, ch. 8, 47 Stat. 5, 5–7 (1932) (repealed 1947).

The Federal Home Loan Bank Act of 1932 established the Federal Home Loan Bank Board (FHLBB), which charters and supervises federal S&Ls, and the Federal Home Loan Banks (FHLBs) to lend to S&Ls to finance home mortgages. See Federal Home Loan Bank Act of 1932, ch. 522, 47 Stat. 725, 725, 726, 730 (1932) (current version at 12 U.S.C. §§ 1421–1449 (2000)); Fred Wright, Comment, *The Effect of New Deal Real Estate*

home mortgage markets, which would continue through the 1940 passages of the Investment Company Act and Investment Advisers Act regulating mutual funds and other pooled investment vehicles and their managers.<sup>77</sup>

Events in the housing markets in the years leading up to the Great Depression exhibited many of the same qualities as today's markets—the real estate markets were responsible for a disproportionate amount of economic activity, homeownership generally required either very large down payments or the willingness to take on interest only mortgages requiring balloon payments, lenders commonly made loans to borrowers with little regard for their abilities to repay, and speculative borrowers and irresponsible lenders stoked a real estate bubble.<sup>78</sup> Recognizing that

*Residential Finance and Foreclosure Policies Made in Response to the Real Estate Conditions of the Great Depression*, 57 ALA. L. REV. 231, 241 (2005).

The Bank Conservation Act of 1933 gave the Office of the Comptroller of the Currency (OCC) authority to appoint a conservator who could force failing banks and S&Ls into receivership. See Bank Conservation Act of 1933, ch. 1, § 203, 48 Stat. 1, 2–3 (1933) (codified in scattered sections of 12 U.S.C.).

The National Housing Act of 1934 provided for the creation of the Federal Savings and Loan Insurance Corporation (FSLIC) to insure deposits of S&Ls. See National Housing Act, ch. 847, § 402(a), 48 Stat. 1246, 1256 (1934) (codified as amended in scattered sections of 12 U.S.C.).

FSLIC was administered by the Federal Home Loan Bank Board (FHLBB) until it went bankrupt in 1989 and the FDIC took it over and created the Savings Association Insurance Fund (SAIF). See Federal Deposit Insurance Corporation, FDIC Learning Bank: the 1930s, <http://www.fdic.gov/about/learn/federal/when/1930s.html> (last visited Feb. 22, 2009) [hereinafter Learning Bank, The 1930s].

77. The Banking Act of 1933 established the FDIC as a temporary government-sponsored company to provide deposit insurance, regulated and supervised state banks not already under federal regulation, extended federal oversight to all commercial banks, separated commercial and investment banking, and prohibited banks from paying interest on checking accounts. See *supra* note 1; Learning Bank, The 1930s, *supra* note 76.

The Securities Act of 1933 instituted a disclosure regime for companies that sought to issue stocks for sale to the general public. *Id.*; *supra* note 1. The Securities Exchange Act of 1934 created the Securities and Exchange Commission (SEC) and mandated companies whose stock traded on exchanges or over the counter file registration statements in connection with their initial offerings and ongoing annual disclosures. *Id.*

The Banking Act of 1935 made the FDIC a permanent institution and made deposit insurance permanent. *Id.* The Federal Credit Union Act of 1935 established credit union oversight, which was originally administered by the Farm Credit Administration, but was transferred to several regulatory bodies and today responsibility for regulating credit unions rests with the National Credit Union Administration. *Id.* The Trust Indenture Act of 1939 gave the SEC responsibility for overseeing corporate issuances of debt securities. *Id.*

78. See Wright, *supra* note 76, at 232–37; see also C. LOWELL HARRISS, HISTORY AND POLICIES OF THE HOME OWNERS' LOAN CORPORATION 8 (1951), available at <http://www.nber.org/books/harr51-1> (discussing the general weakness of the housing market prior to the great depression). Commentators have noted a possible outcome of market collapse:

Here is an idea of the potential impact of a total collapse of the real estate market: the real estate mortgage debt in 1932 of \$43 billion was three times that of total railroad debt; four times that of industrial long-term debt; and nearly the same size as that of the combined federal, state, county, and municipal debt.

*Id.*

When testifying before the U.S. Senate, Eric Stein, senior vice president of the Center For Responsible Lending, observed that “[f]rom 2000 through year-end 2005, median real wages grew just 1.7%, while real housing prices grew 22%.” *Turmoil in the U.S. Credit Markets: The Genesis of the Current Economic Crisis Before the Subcomm. on Banking, Housing and Urban Affairs*, 110th Cong. 11 (2008) (statement of Eric Stein, Senior Vice President, Center for Responsible Lending), available at <http://www.responsiblelending.org/pdfs/senate-testimony-10-16-08-hearing-stein-final.pdf>. Furthermore, “[t]he combination of real housing price increases and flat or declining wages resulted in an unsustainable, and unstable, environment.” *Id.*

a speculative bubble was forming, in 1928 the Federal Reserve began tightening monetary policy to increase interest rates and in 1929 the bubble burst as the stock markets and economy, in general, slid into a depression.<sup>79</sup> Deleveraging in the financial and housing markets led to contraction in the real economy leading to massive layoffs, home foreclosures, corporate and personal bankruptcies, and deflation, feeding into a downward spiral of further layoffs, foreclosures and bankruptcies.<sup>80</sup>

In 1932, lenders foreclosed on more than 250,000 homes.<sup>81</sup> In an attempt to combat the foreclosure crisis, Congress passed the first piece of federal legislation that would give the federal government a permanent role in the housing markets, the Federal Home Loan Bank Act of 1932 (FHLBA).<sup>82</sup> FHLBA established the Federal Home Loan Banks (FHLBs) to help provide discounted funding for new home purchases.<sup>83</sup> The FHLBs were relatively ineffective at preventing further deterioration in the housing markets because, as home prices and employment continued to spiral out of control, even those who could afford to take on new mortgages were hesitant to commit to long-term mortgage payments.<sup>84</sup>

Congress passed the Home Owners' Loan Act of 1933 establishing the Home Owners Loan Corporation (HOLC).<sup>85</sup> In a 1951 treatise on the Home Owners Loan Corporation, C. Lowell Harris explained the economic situation leading up to its creation:

*In March 1933, millions of people faced the loss of their homes, lenders faced heavy investment losses, communities badly in need of funds suffered from an inability to collect property taxes, and the construction industry, which if revived would contribute significantly to general economic recovery, was at a virtual standstill.*<sup>86</sup>

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See also Robert J. Shiller, *Infectious Exuberance*, THE ATLANTIC, July/Aug. 2008, available at <http://www.theatlantic.com/doc/200807/housing> (discussing the psychology of asset bubbles).

Declines in housing and stock markets lead to dramatic declines in household wealth. For example, in 2008 household net worth fell \$11.2 trillion, to \$51.5 trillion. See BD. OF GOV. OF THE FED. RES. SYSTEM, FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES (Mar. 12, 2009), available at <http://www.federalreserve.gov/releases/z1/Current/z1.pdf>.

79. See, e.g., David C. Wheelock, *The Federal Response to Home Mortgage Distress: Lessons from the Great Depression*, 90 FED. RES. BANK ST. LOUIS REV. 133, 135 n.10, 137, available at <http://research.stlouisfed.org/publications/review/08/05/Wheelock.pdf> (discussing housing market trends prior to and during the Great Depression).

80. See Wright, *supra* note 76, at 232, 236, 238–40 (discussing how the real estate market collapsed during the Great Depression leading to more foreclosures, bankruptcies and unemployment).

81. See Wheelock, *supra* note 79, at 570.

82. See Federal Home Loan Bank Act of 1932, ch. 522, 47 Stat. 725 (1932) (codified as amended at 12 U.S.C. §§ 1421–1449 (2000)); Wright, *supra* note 76, at 241.

83. See HARRISS, *supra* note 78, at 8.

84. *Id.*

85. See Home Owners' Loan Act of 1933, ch. 64, 48 Stat. 128, 128–29 (1933) (codified as amended at 12 U.S.C. §§ 1461–1468 (2000)); Wright, *supra* note 76, at 242.

86. See HARRISS, *supra* note 78, at 8–9.

HOLC provided homeowners who were in default the opportunity to consolidate their housing-related obligations and refinance into low-interest mortgages.<sup>87</sup> The Department of Treasury provided \$200 million in financing for HOLC and HOLC was authorized to issue up to \$2 billion of tax-exempt bonds, which was later increased to \$4.75 billion, either for cash or to exchange with private lenders for home mortgages.<sup>88</sup> HOLC also created standard guidelines for home appraisals.<sup>89</sup>

The following year Congress passed the National Housing Act of 1934, which created the Federal Housing Administration (FHA).<sup>90</sup> In order to stimulate the housing markets, FHA provided mortgage insurance to protect private lenders from losses if the insured mortgage ended up in foreclosure, provided that the loans met criteria defined by federal regulators.<sup>91</sup> In order to qualify for FHA insurance, the mortgage had to meet specific criteria including a 5% interest rate cap and the loans were required to be fully amortizing, so balloon payments and interest only products were prohibited.<sup>92</sup> Four years later, the Federal National Mortgage Association (Fannie Mae), a government-sponsored enterprise (GSE), was created to finance home mortgages in the secondary market.<sup>93</sup>

As the federal government worked to address the housing finance problems that came to a head during the Great Depression, state legislatures across the country set out to protect homeowners from unnecessary foreclosures.<sup>94</sup> In order to combat the foreclosure crisis, 33 states passed legislation to protect struggling mortgage borrowers, including 28 states that passed legislation mandating foreclosure moratoriums.<sup>95</sup> State courts often refused to hold borrowers accountable for the balance of their defaulted mortgages after foreclosure sales failed to cover the full amounts owed.<sup>96</sup>

87. See Wright, *supra* note 76, at 242 (citations omitted).

88. See HARRISS, *supra* note 78, at 11.

89. See Wright, *supra* note 76, at 242 (citations omitted).

90. See National Housing Act, ch. 847, 48 Stat. 1246 (1934) (codified as amended in scattered sections of 12 U.S.C.); Wright, *supra* note 76, at 251.

91. See Nathalie Martin, *The Role of History and Culture in Developing Bankruptcy and Insolvency Systems: The Perils of Legal Transplantation*, 28 B.C. INT'L & COMP. L. REV. 1, 15 (2005). In 1965, FHA became part of the Department of Housing and Urban Development (HUD). See U.S. Dep't of Housing & Urban Dev., The Federal Housing Administration, <http://www.hud.gov/offices/hsg/fhahistory.cfm>. (last visited Feb. 23, 2009).

92. See Wheelock, *supra* note 79, at 144.

93. See Workshop, *Overcoming Discrimination in Housing, Credit, and Urban Policy*, 25 BUFF. PUB. INT. L.J. 77, 92 n.22 (2006); Fannie Mae, About Fannie Mae, <http://www.fanniemae.com/aboutfm/charter.jhtml> (last visited Feb. 25, 2009) [hereinafter Fannie Mae, About Fannie Mae].

94. Wright, *supra* note 76, at 240–41 (analyzing federal and state responses to the foreclosure crisis in the 1930s).

95. See Wheelock, *supra* note 79, at 140 (citations omitted).

96. Wright, *supra* note 76, at 241 (discussing state courts in New York and Illinois that “refused to allow deficiency judgments”).

Congress passed several pieces of federal legislation in the following decades aimed at protecting borrowers, but generally permitted states to maintain their primacy as enforcers of consumer protection standards.<sup>97</sup>

### B. Deregulation of Mortgage Markets

The New Deal system of housing finance lasted until the economic turmoil of the 1970s. Rising interest rates in the late 1970s and early 1980s put pressure on banks and savings and loans (S&Ls), which had long been major providers of real estate loans to U.S. borrowers.<sup>98</sup> Banks and S&Ls were being forced to pay higher interest rates to finance their lending activities but caps on the interest rates they were permitted to charge borrowers made it nearly impossible to operate profitably.<sup>99</sup>

Throughout U.S. history, state usury laws capped interest rates lenders were permitted to charge consumer borrowers, but that changed when Congress passed the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA), which preempted interest rate caps imposed by states.<sup>100</sup> By preempting state usury laws and in other ways discussed later in this article, DIDMCA

97. In 1968, as part of the Consumer Protection Act, Congress passed the Truth in Lending Act (TILA), Pub. L. No. 90-321, 82 Stat. 146 (1968) (codified as amended at scattered sections in 15 U.S.C.), to ensure that lenders provide borrowers with meaningful disclosures that clearly define the loan terms. The Home Mortgage Disclosure Act of 1975 (HMDA), 12 U.S.C. §§ 2801–2810 (2006), encouraged banks and S&Ls to provide mortgages for low and moderate income borrowers and required these institutions to record their lending practices. See Michael S. Barr, *Modes of Credit Market Regulation*, in BUILDING ASSETS BUILDING WEALTH: CREATING WEALTH IN LOW-INCOME COMMUNITIES 206 (Nicolas P. Retsinas & Eric S. Belsky eds., 2005). The Equal Credit Opportunity Act, 15 U.S.C. §§ 1691–1691f (2000), (EEOA) passed in 1974, prohibits discrimination in lending decisions. See C. Lincoln Combs, Comment, *Banking Law and Regulation: Predatory Lending in Arizona*, 38 ARIZ. ST. L.J. 617, 624 (2006). The Community Reinvestment Act of 1977 (CRA), 12 U.S.C. §§ 2901–2908 (2006), attempted to ensure that low income and minority communities had access to credit and deposit services. See Marcia Johnson, JaPaula Kemp & Anh Nguyen, *The Community Reinvestment Act: Expanding Access*, 12 KAN. J.L. & PUB. POL'Y 89, 89 (2002–2003). Homeowner's Equity Protection Act of 1994 (HOEPA), Pub. L. No. 103-325, 108 Stat. 2160 (1994) (codified as amended in scattered sections of 15 U.S.C.), defines unfair and deceptive practices in mortgage lending. See Barr, *supra*, at 206; see also Michelle W. Lewis, *Perspectives on Predatory Lending: The Philadelphia Experience*, 12 J. AFFORDABLE HOUSING & C.MTY. DEV. L. 491, 493 (2003) (noting the specific definition of predatory lending found in HOEPA).

98. EDWARD J. KANE, DEREGULATION, SECURITIES AND LOAN DIVERSIFICATION, AND THE FLOW OF HOUSING FINANCE, SAVING AND LOAN ASSET MANAGEMENT UNDER DEREGULATION 80–109; San Francisco: Federal Home Loan Bank, 1981 (Proceedings of Sixth Annual Conference).

99. See OFFICE OF THRIFT SUPERVISION, DEP'T OF THE TREASURY, ANNUAL REPORT FOR FISCAL YEAR 2008 (2008), available at <http://files.ots.treas.gov/482013.pdf> (last visited Feb. 24, 2009). The higher interest rates in the 1970s made competing more difficult for banks and S&L's, as they were forced to pay higher interest rates and forced to derive their income from relatively lower yielding home mortgages while the activities of non-banks remained unregulated. *Id.*; see also Grant L. Kratz, Comment, *Franklin Savings v. Office of Thrift Supervision: A Case of Judicial Interpretation Creating a Due Process Dragon*, 6 BYU J. PUB. L. 587, 587 (1992) (noting that the inability of savings and loans to make a profit was due to the fact that the "interest rates they were charging on long term mortgages fell short of the average cost of funds to the institution"); Carl Felsenfeld, *The Savings and Loan Crisis*, 59 FORDHAM L. REV. 57, S16–17 (1991) (explaining that the state usury laws limiting the interest rates that S&Ls could charge to borrowers were a contributing factor to the instability of S&Ls).

100. Felsenfeld, *supra* note 99, at S17. Through the 1970's, usury laws "limited the interest that could be charged on consumer real estate loans." *Id.* Though "ceiling rates varied from a low of six percent to a high of twelve percent, over half of the states had ceilings of eight percent or less." *Id.*; see also Depository Institutions

began the gradual erosion of regulations that both prevented systemic risk in the financial services industry and protected consumers from predatory creditors.<sup>101</sup>

Two years later, the Alternative Mortgage Transactions Parity Act of 1982 (AMTPA) lifted restrictions on lenders' ability to offer adjustable rate mortgages.<sup>102</sup> The Act gave the primary federal banking regulators exclusive authority to regulate the "alternative mortgage transaction[s]" undertaken by entities under their respective jurisdictions.<sup>103</sup>

According to McCoy and Renuart,

*Federal deregulation permitted lenders to charge a risk premium to less creditworthy borrowers in the form of higher interest rates and fees. Equally importantly, deregulation allowed lenders to market new and more complex types of mortgage products, including adjustable-rate mortgages and loans with balloon payments and negative amortization, which expanded the pool of eligible borrowers and helped lenders control for interest-rate risk.*<sup>104</sup>

In 1982, Congress also passed the Garn-St. Germain Act, which preempted state laws that prevented out-of-state banks from buying failed banks and thrifts.<sup>105</sup> Garn-St. Germain also permitted thrifts to expand their businesses beyond mortgage lending into commercial lending, credit cards, and real estate investing.<sup>106</sup>

Deregulation and Monetary Control Act of 1980 (DIDMCA), Pub. L. No. 96-221, 94 Stat. 132 (codified as amended in scattered sections of 12 U.S.C.).

101. *Id.*

The provisions of the constitution or the laws of any State expressly limiting the rate or amount of interest, discount points, finance charges, or other charges which may be charged, taken, received, or reserved shall not apply to any loan, mortgage, credit sale, or advance which is (A) secured by a first lien on residential real property, by a first lien on all stock allocated to a dwelling unit in a residential cooperative housing corporation . . . or by a first lien on a residential manufactured home . . . .

12 U.S.C. § 1735f-7a(1) (2000); *see also* Alex M. Azar II, Note, *FIRREA: Controlling Savings and Loan Association Credit Risk Through Capital Standards and Asset Restrictions*, 100 *YALE L. J.* 149, 153 (1990) (explaining that the passing of DIDMCA phased out the caps on interest rates paid to depositors and allowed S&Ls to diversify their investment portfolios).

102. 12 U.S.C §§ 3801–3806 (2000); *see also* 12 U.S.C. § 3803(c) (2000) ("An alternative mortgage transaction may be made by a housing creditor in accordance with this section, notwithstanding any State constitution, law, or regulation.").

103. 12 U.S.C. § 3803(c).

104. Patricia A. McCoy and Elizabeth Renuart, *The Legal Infrastructure of Subprime and Nontraditional Home Mortgages*, in *BORROWING TO LIVE: CONSUMER AND MORTGAGE CREDIT REVISITED* 110 (Nicolas P. Retsinas & Eric S. Belsky, eds., 2008).

105. Pub. L. No. 97-320, 96 Stat. 1469 (codified as amended in scattered sections of 12 U.S.C.); *see also* Randall S. Kroszner & Philip E. Strahan, *What Drives Deregulation? Economics and Politics of the Relaxation of Bank Branching Restrictions*, 114 *Q. J. ECON.* 1437, 1442 (1999); Laurie S. Goodman & Sherrill Shaffer, *The Economics of Deposit Insurance: A Critical Evaluation of Proposed Reforms*, 2 *YALE J. ON REG.* 145, 150 n.29 (1984).

106. Terry Carter, *How Lawyers Enabled the Meltdown: And How They Might Have Prevented It*, 95 *A.B.A. J.*, Jan. 2009, at 34, 34.

A final stimulus for the rapid growth in mortgage lending that occurred in the late 1980s and again in the early 2000s came from the Tax Reform Act of 1986 (TRA).<sup>107</sup> TRA made residential mortgages unique in that the Act made interest on home mortgages the only type of interest paid by consumers that is tax deductible.<sup>108</sup> This had the unintended consequence of creating an incentive for borrowers to take out home equity lines of credit instead of using credit cards to finance personal consumption, putting their homes at risk if they were unable to pay off their debts.<sup>109</sup>

The deregulation of the early 1980s enabled S&Ls to make risky loans to finance real estate acquisitions.<sup>110</sup> Falling real estate and oil prices later in the decade, however, caused many of these projects to fail.<sup>111</sup> These large losses eventually pushed so many S&Ls into bankruptcy that the Federal Savings and Loan Insurance Corporation (FSLIC), which had provided deposit insurance to S&Ls since the 1930s, became insolvent as well.<sup>112</sup>

By 1989, the S&L crisis had raised legitimate concerns among policymakers about the prudence of banking deregulation and Congress passed Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) in an effort to

107. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (codified as amended in scattered sections of 26 U.S.C.).

108. See Raymond H. Brescia, *Capital in Chaos: The Subprime Mortgage Crisis and the Social Capital Response*, 56 CLEV. ST. L. REV. 271, 288 (2008) (noting that as a result of the Tax Reform Act of 1986, the interest paid on residential mortgages became the only consumer loans where the interest paid was tax deductible).

109. Baher Azmy, *Squaring the Predatory Lending Circle*, 57 FLA. L. REV. 295, 310–11 (2005) (explaining that funding expenses with mortgage debt became more attractive to consumers than funding their expenses by credit cards and personal loans because the TRA “eliminated the federal income tax deduction of consumer interest for all purposes except home mortgages”).

[S]ubprime lending would not become a viable large-scale lending alternative until the Tax Reform Act of 1986 (TRA). The TRA increased the demand for mortgage debt because it prohibited the deduction of interest on consumer loans, yet allowed interest deductions on mortgages for a primary residence as well as one additional home. This made even high-cost mortgage debt cheaper than consumer debt for many homeowners. In environments of low and declining interest rates, such as the late 1990s and early 2000s, cash-out refinancing becomes a popular mechanism for homeowners to access the value of their homes. In fact, slightly over one-half of subprime loan originations have been for cash-out refinancing.

Souphala Chomsisengphet & Anthony Pennington-Cross, *The Evolution of the Subprime Mortgage Market*, 88 FED. RES. BANK ST. LOUIS REV. 31, 38 (2006) (footnotes omitted).

110. Federal Deposit Insurance Corporation, FDIC Learning Bank: The 1980s, <http://www.fdic.gov/about/learn/learning/when/1980s.html> (last visited February 23, 2009) [hereinafter Learning Bank, The 1980s].

111. Roger D. Citron, *Lessons from the Damages Decisions Following United States v. Winstar Corp.*, 32 PUB. CONT. L.J. 1, 9 (2002) (noting that the decline experienced by the real estate business in the late 1980s was subsequent to the fall in oil and commercial real estate prices).

112. CONGRESSIONAL OVERSIGHT PANEL, APRIL OVERSIGHT REPORT, ASSESSING TREASURY’S STRATEGY: SIX MONTHS OF TARP 44–50 (Apr. 7, 2009) (discussing events leading up to the Savings & Loan crisis and government responses implemented to resolve the crisis); *United States v. Winstar Corp.*, 518 U.S. 839, 846–47 (1996) (noting that the failed savings and loans confronted FSLIC with deposit insurance liabilities, leading the corporation to become insolvent by over \$50 billion by 1998); Richard Wei, Note, *United States v. Winstar: Renewed Government Liability Arising from the Savings and Loans Crisis*, 1 N.C. BANKING INST. 366, 368 (1997); Learning Bank, The 1980s, *supra* note 110.

reregulate the industry.<sup>113</sup> The main purpose of FIRREA was to strengthen regulation of S&Ls and to enhance regulators' enforcement powers.<sup>114</sup>

### C. Preemption of State Consumer Protection Laws

FIRREA created the Office of Thrift Supervision (OTS) and gave it "the plenary and exclusive authority . . . to regulate all aspects of the operations of Federal [S&Ls]."<sup>115</sup> As a result, OTS regulations are "preemptive of any state law purporting to address the subject of the operations of a Federal savings association."<sup>116</sup> This authority allows the OTS to preempt state laws and regulate "the powers and operations of every Federal [S&L] from its cradle to its corporate grave."<sup>117</sup>

OTS regulations generally preempt state regulations and enforcement actions unless they only "incidentally affect the lending operations of Federal [S&Ls]."<sup>118</sup> But the federal regulators were often slow to implement consumer protections and their enforcement was generally weak, compared to the state laws they preempted.<sup>119</sup> For example, the Federal Reserve waited until the end of 2001 to implement regulations under the Home Ownership and Equity Protection Act of 1994 (HOEPA) that created substantive limitations on the types of loans that could be sold to consumers.<sup>120</sup> This was after a nearly 400% increase in the volume of sub-prime loans.<sup>121</sup> Similarly, the Federal Reserve Board waited until 2008, in the midst

113. FDIC, *The Banking Crises of the 1980s and Early 1990s: Summary and Implications*, in HISTORY OF THE 80s—LESSONS FOR THE FUTURE 3, 10 (1997), available at <http://www.fdic.gov/databank/hist80>.

114. *Id.*

115. 12 C.F.R. § 545.2 (2007).

116. *Id.*

117. *Fid. Fed. Sav. & Loan Ass'n v. de la Cuesta*, 458 U.S. 141, 145 (1982) (quoting *People v. Coast Fed. Sav. & Loan Ass'n*, 98 F. Supp. 311, 316 (S.D. Cal. 1952)).

118. 12 C.F.R. § 560.2(c) (2007).

119. See Jessica Fogel, *State Consumer Protection Statutes: An Alternative Approach to Solving the Problem of Predatory Mortgage Lending*, 28 SEATTLE U. L. REV. 435, 451–52 (2005) (comparing the weak enforcement provisions in federal lending statutes to state anti-predatory lending statutes, which generally include the following comprehensive provisions: "limiting the interest rates and fees that a lender may charge; precluding lending to borrowers without regard to their ability to repay; requiring refinance loans to provide a net tangible financial benefit to the borrower; prohibiting excessive prepayment penalties; requiring disclosure to the borrower of various loan provisions; and requiring counseling for borrowers who are planning to take out certain loans that are governed by these laws"). More recently, Chairman Bernanke has said the Board would "consider whether other lending practices meet the legal definition of unfair and deceptive and thus should be prohibited under HOEPA." Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, Address at the Federal Reserve Bank of Chicago's 43rd Annual Conference on Bank Structure and Competition (May 17, 2007), available at [www.federalreserve.gov/newsevents/speech/bernanke20070517a.htm](http://www.federalreserve.gov/newsevents/speech/bernanke20070517a.htm). In 2008, nearly 20 years after FIRREA's preemption of state laws regulating S&Ls, that the Federal Reserve published final rules that applied key protections for consumers to amend federal regulations. See *Truth in Lending*, 73 Fed. Reg. 44,522 (July 30, 2008) (to be codified at 12 C.F.R. pt. 226).

120. See *Truth in Lending*, 66 Fed. Reg. 65,604, 65,605 (Dec. 20, 2001) (to be codified at 12 C.F.R. pt. 226); see also OFFICE OF THE COMPTROLLER OF THE CURRENCY, *TRUTH IN LENDING: COMPTROLLER'S HANDBOOK 2* (2008), available at <http://www.occ.treas.gov/handbook/til.pdf>.

121. CONGRESSIONAL OVERSIGHT PANEL, *SPECIAL REPORT ON REGULATORY REFORM: MODERNIZING THE AMERICAN FINANCIAL REGULATORY SYSTEM: RECOMMENDATIONS FOR IMPROVING OVERSIGHT, PROTECTING CONSUMERS, AND ENSURING STABILITY* 36 n.63 (2009).



of the subprime mortgage crisis, to implement changes to the regulations under the Truth in Lending Act (TILA) “to protect consumers in the mortgage market from unfair, abusive, or deceptive lending and servicing practices” and “ensure that advertisements for mortgage loans provide accurate and balanced information and do not contain misleading or deceptive representations . . . .”<sup>122</sup>

DIDMCA and AMTPA, together with the courts’ interpretations that these acts overrode the application of most state consumer protections and the federal regulators’ general reluctance to implement and enforce consumer protection regulations were a lethal combination.<sup>123</sup> These factors paved the way for risky, and often predatory, mortgage lending standards to replace more responsible practices.<sup>124</sup>

There is a general perception that predatory lending practices have been concentrated in the non-banking institutions that are not regulated by state or federal banking regulators.<sup>125</sup> However, the data suggests the problem may be a combination of a lack of regulatory coverage with weak federal regulators.<sup>126</sup> In 2005, 52% of subprime mortgages were originated by companies that were subject to some federal regulation.<sup>127</sup> Financial institutions including Citigroup and HSBC, two of the largest consumer lending institutions regulated at the federal level, have been forced to pay large penalties to settle predatory lending allegations against their subsidiaries.<sup>128</sup>

122. Truth in Lending, 73 Fed. Reg. 1672 (Jan. 9, 2008) (codified at 12 C.F.R. pt. 226).

The final rule applies four protections to a newly defined category of higher-priced mortgage loans secured by a consumer’s principal dwelling, including a prohibition on lending based on the collateral without regard to consumers’ ability to repay their obligations from income, or from other sources besides the collateral. The revisions apply two new protections to mortgage loans secured by a consumer’s principal dwelling regardless of loan price, including a prohibition on abusive servicing practices. The Board is also finalizing rules requiring that advertisements provide accurate and balanced information, in a clear and conspicuous manner, about rates, monthly payments, and other loan features. The advertising rules ban several deceptive or misleading advertising practices, including representations that a rate or payment is “fixed” when it can change. Finally, the revisions require creditors to provide consumers with transaction-specific mortgage loan disclosures within three business days after application and before they pay any fee except a reasonable fee for reviewing credit history.

Truth in Lending, 73 Fed. Reg. 44,522 (July 30, 2008) (codified at 12 C.F.R. § 226).

123. See Sally Pittman, *Arms, But No Legs to Stand On: “Subprime” Solutions Plague the Subprime Mortgage Crisis*, 40 TEX. TECH. L. REV. 1089, 1093–96 (2008); Jon Birger, *How Congress Helped Create the Subprime Mess*, FORTUNE, Jan. 31, 2008, [http://money.cnn.com/2008/01/30/real\\_estate/congress\\_subprime.fortune/](http://money.cnn.com/2008/01/30/real_estate/congress_subprime.fortune/) (pointing the AMTPA and DIDMCA as the “root of the current mortgage crisis”).

124. See Birger, *supra* note 123; Pittman, *supra* note 123, at 1093–96.

125. See Greg Ip & Damian Paletta, *Lending Oversight: Regulators Scrutinized in Mortgage Meltdown*, WALL ST. J., Mar. 22, 2007, at A1 (“Changes in the lending business and financial markets have moved large swaths of subprime lending from traditional banks to companies outside the jurisdiction of federal [and state] banking regulators.”).

126. *Id.*

127. *Id.*

128. See Christopher L. Peterson, *Preemption, Agency Cost Theory, and Predatory Lending by Banking Agents: Are Federal Regulators Biting Off More Than They Can Chew?*, 56 AM. U. L. REV. 515, 522 (2007).

## D. GSEs—Privatizing Public Institutions

After Fannie Mae was founded in 1938, its success in providing liquidity to the mortgage markets led the government to create additional government-sponsored enterprises (GSEs) to provide mortgage financing, including Ginnie Mae and Freddie Mac.<sup>129</sup> Fannie Mae operated as a government agency during its first 30 years and was only permitted to purchase FHA-insured mortgages.<sup>130</sup> In 1968, Fannie Mae was split into two separate entities—Ginnie Mae and Fannie Mae.<sup>131</sup> Ginnie Mae remained a government agency and was directed to provide mortgage financing for special government projects.<sup>132</sup> Fannie Mae, however, became a “government-sponsored private corporation”, owned by public stockholders and run like a public company.<sup>133</sup> The 1968 Charter Act transformed Fannie Mae into a profit-seeking, shareholder owned company, tasked with creating a secondary market for mortgages made to low- and moderate-income borrowers.<sup>134</sup>

In order to create a secondary market for conventional mortgage, Congress passed the Emergency Home Finance Act of 1970, which both expanded Fannie Mae’s authority to operate in the conventional mortgage markets and created another GSE, Freddie Mac, to serve this purpose.<sup>135</sup> The modern securitization market was developed in the 1970s to allow Freddie Mac access to larger amounts capital to finance home mortgages.<sup>136</sup> The other GSEs and private lenders began securitizing mortgages in the 1980s.<sup>137</sup> By 1993, 60% of newly originated home mortgage were securitized.<sup>138</sup>

129. See Fannie Mae, About Fannie Mae, *supra* note 93. Fannie Mae was created in 1938 and was administered by FHA “to purchase, hold, or sell FHA-insured mortgage loans that had been originated by private lenders.” *Id.* After World War II, Fannie Mae expanded to provide mortgage loans for veterans. *Id.* In 1968, Fannie Mae was split into two entities, the Government National Mortgage Association (Ginnie Mae) and Fannie Mae. *Id.* Ginnie Mae remained under government control and was operated with the explicit purpose of providing mortgages to underserved communities and Fannie Mae became a private organization and was authorized to issue mortgage backed securities to finance its activities in the secondary mortgage markets. *Id.* The Federal Home Loan Mortgage Corporation (Freddie Mac) was created by the Emergency Home Finance Act of 1970 to finance conventional mortgages in the secondary markets. *Id.*

130. FANNIE MAE, AN INTRODUCTION TO FANNIE MAE 3 (2008), available at [http://www.fanniemae.com/media/pdf/fannie\\_mae\\_introduction.pdf](http://www.fanniemae.com/media/pdf/fannie_mae_introduction.pdf) [hereinafter FANNIE MAE, INTRODUCTION] (“At first, Fannie Mae, as a government agency, was authorized to only buy Federal Housing Administration (FHA)-insured mortgages, thereby replenishing the supply of lendable money for these government-backed loans.”).

131. National Housing Act, 12 U.S.C. § 1717 (2006); Fannie Mae, About Fannie Mae, *supra* note 93.

132. 12 U.S.C. § 1717; Fannie Mae, About Fannie Mae, *supra* note 93 (“Ginnie Mae would continue as a federal agency and be responsible for the then-existing special assistance programs . . .”).

133. Fannie Mae, About Fannie Mae, *supra* note 93.

134. National Housing Act, 12 U.S.C. § 1717; Fannie Mae, About Fannie Mae, *supra* note 93.

135. Emergency Home Finance Act of 1970, Pub. L. No. 91-351, § 303, 305, 84 Stat. 450 (1970); see also Fannie Mae, About Fannie Mae, *supra* note 93.

136. Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255, 1273 (2002).

137. *Id.*

138. *Id.*

In 1992, the Federal Housing Enterprises Financial Safety and Soundness Act transferred regulatory responsibility for Fannie Mae, Freddie Mac and the 12 Federal Home Loan Banks to the Office of Federal Housing Enterprise Oversight (OFHEO).<sup>139</sup> OFHEO was responsible for overseeing the safety and soundness of the GSEs and the Act directed OFHEO to establish minimum capital requirements and set up regular examinations.<sup>140</sup> After OFHEO was established, HUD retained general authority to regulate Fannie Mae and Freddie Mac.<sup>141</sup>

GSE requirements became the standard in home mortgage lending and until 2003 most mortgage originations were underwritten to conform with the requirements defined by Fannie Mae and Freddie Mac for loans that they were willing to finance in the secondary markets.<sup>142</sup>

The subprime crisis, however, really began when in 2004 private companies' issuance of mortgage-backed securities surpassed Fannie Mae's for the first time in history with private companies issuing \$809 billion and Fannie Mae issuing \$537 billion.<sup>143</sup>

The combination of the conversion of the GSEs into for-profit enterprises with the competition they faced from deregulated competitors proved to be an irresistible temptation for the GSEs.<sup>144</sup> Although the GSEs were neither the primary actors in the subprime fiasco nor the cause of the financial crisis, as some conservative commentators have asserted, they did become fatally infected with the disease of overleverage and indifference to risk in the pursuit of unsustainable returns.<sup>145</sup>

139. Federal Housing Enterprises Financial Safety and Soundness Act, Pub. L. No. 102-550, § 1311, 106 Stat. 3941, 3944 (1992).

140. *Housing Enterprises: The Roles of Fannie Mae and Freddie Mac in the U.S. Housing Financing System Before the Task Force on Housing & Infrastructure of the H. Comm. on the Budget*, 106th Cong. 3 (2000) (statement of Thomas J. McCool, Director, Financial Institutions & Markets Issues, General Government Division, General Accounting Office), available at <http://www.gao.gov/archive/2000/gg00182t.pdf>.

141. *Id.*

142. John Kiff & Paul S. Mills, *Money for Nothing and Checks for Free: Recent Developments in U.S. Subprime Mortgage Markets* 6 (Int'l Monetary Fund, Working Paper No. 188, 2007), available at <http://ssrn.com/abstract=1006316>.

Fannie Mae's activities enhance the liquidity and stability of the mortgage market and contribute to making housing in the United States more affordable and more available to low-, moderate- and middle-income Americans. These activities include providing funds to mortgage lenders through [the] purchases of mortgage assets, and issuing and guaranteeing mortgage-related securities that facilitate the flow of additional funds into the mortgage market[s].

FED. NAT'L MORTGAGE ASS'N, ANNUAL REPORT (Form 10-K), at 1 (Dec. 31, 2007).

143. FANNIE MAE, SINGLE FAMILY GUARANTY BUSINESS: FACING STRATEGIC CROSSROADS 23 (2005) [hereinafter STRATEGIC CROSSROADS], available at <http://oversight.house.gov/documents/20081209103003.pdf>.

144. See Paul Krugman, *Fannie, Freddie and You*, N.Y. TIMES, Jul. 14, 2008, at A21, available at [http://www.nytimes.com/2008/07/14/opinion/14krugman.html?\\_r=1&scp=3&sq=fannie%20mae&st=Search](http://www.nytimes.com/2008/07/14/opinion/14krugman.html?_r=1&scp=3&sq=fannie%20mae&st=Search) (explaining that, while the GSEs did not maintain a sufficient capital base, they did not originate subprime mortgages); James R. Hagerly, *U.S. News: U.S. Rethinks Roles of Fannie, Freddie*, WALL ST. J., Dec. 1, 2008, at A5 (noting that the GSE's were conflicted between a desire to gain maximum profits and the reality of their responsibilities to the housing industry).

145. See Krugman, *supra* note 144; Michael S. Barr & Gene Sperling, *Poor Homeowners, Good Loans*, N.Y. TIMES, Oct. 17, 2008, at A23 (explaining that conservatives have blamed Democrats' efforts to promote low-

A 2005 presentation prepared by Fannie Mae former CEO Daniel Mudd raised alarms that Wall Street firms were moving into its market and flagged Lehman Brothers and Bear Stearns as new competitors.<sup>146</sup> Mudd's presentation outlined the decision Fannie Mae faced to either maintain its business focus on safe, prime mortgages or move into the risky subprime market to increase profits and maintain its competitive edge.<sup>147</sup>

According to a 2008 written statement from Congressman Henry Waxman, then chair of the House Oversight Committee:

*The documents make clear that Fannie Mae and Freddie Mac knew what they were doing. Their own risk managers raised warning after warning about the dangers of investing heavily in the subprime and alternative mortgage market, but these warnings were ignored.*

*In a presentation given in 2007, Fannie Mae's management told the board:*

*"We want to go down the credit spectrum. . . . Subprime spreads have widened dramatically to their widest level in years. We do not feel there is much risk going down to AA and A. We don't expect to take losses at AA and A level. Eventually, we want to go to BBB. We want to move quickly while the opportunity is still [t]here. . . ."*

*Taking these risks proved tremendously lucrative for Fannie and Freddie's CEOs. They made over \$40 million between 2003 and 2007. But their irresponsible decisions are now costing the taxpayers billions of dollars.*<sup>148</sup>

Like many others on Wall Street, Fannie Mae and Freddie Mac took on excessive long-term risks to enhance short-term profits and are now paying the price.<sup>149</sup> Also, like many on Wall Street, regulators were ill-equipped to oversee the GSEs and require them to avoid riskier business lines.<sup>150</sup>

Shortly before the explosion of the subprime mortgage markets in 2001, Congress slashed the budget for Office of Federal Housing Enterprise Oversight

and moderate-income housing for creating the financial crisis but the facts do not support these claims); James R. Hagerty, *The Financial Crisis: Bailout Politics: Fannie, Freddie Share Spotlight in Mortgage Mess—Government-Backed Mortgage Giants Are Targets in Political Debate Over What Sparked the Housing Bust*, WALL ST. J., Oct. 16, 2008, at A6 [hereinafter Hagerty, *Financial Crisis*].

146. STRATEGIC CROSSROADS, *supra* note 143, at 25.

147. See *id.* at 5–11.

148. *The Role of Fannie Mae and Freddie Mac in the Financial Crisis Before the H. Comm. on Oversight and Government Reform*, 110th Cong. 4–6 (2008) (statement of Rep. Henry A. Waxman, Chairman, Committee on Oversight and Government Reform), available at <http://oversight.house.gov/documents/20090209155117.pdf>.

149. See Krugman, *supra* note 144; Hagerty, *Financial Crisis*, *supra* note 145 (noting the significant losses faced by Fannie Mae and Freddie Mac).

150. See Jack Guttentag, *Loan Regulation Probably Wouldn't Have Prevented This Crisis*, WASH. POST, Oct. 18, 2008, at F9 (noting that because the economic structure was changing, previously relied upon statistics and experience were rendered irrelevant, thereby leaving the regulators unable to anticipate and react to the crisis).

(OFHEO), the regulator that oversaw Fannie Mae and Freddie Mac, by nearly 18%.<sup>151</sup>

The GSEs, however, remain critical providers of mortgage finance in this country.<sup>152</sup> Despite a brief period from 2003 through 2006 when private-label securitizations became the primary source of mortgage financing, the GSEs remain the largest financiers of U.S. residential mortgages.<sup>153</sup> As of December 31, 2007, the GSEs held more than 45% of the total outstanding mortgage debt in the U.S.<sup>154</sup> The GSEs' importance as providers of capital to the mortgage markets is even more important in times of economic stress. Fannie Mae and Freddie Mac currently finance 75% of new mortgages.<sup>155</sup>

### E. *The Explosion of Subprime Lending*

This long-term decline in the regulation of the mortgage industry, and in particular, the boom in unregulated non-GSE financed lending after 2001, set the stage for an explosion of high cost, exotic mortgage products offered to subprime borrowers.<sup>156</sup> In 2001, subprime lending represented 7.2% of mortgage originations but exploded over the next five years until they reached 20% of mortgage originations in 2006.<sup>157</sup> The breakdown of subprime mortgage by type illustrates the prevalence

151. Press Release, Office of Fed. Hous. Enter. Oversight, Fannie Mae/Freddie Mac Regulator Appeals to House Appropriations Committee for Full Budget (June 5, 2000) (available at [http://www.ofheo.gov/media/archive/docs/press/PR\\_Approps\\_6\\_5\\_00.pdf](http://www.ofheo.gov/media/archive/docs/press/PR_Approps_6_5_00.pdf)).

152. Zachary A. Goldfarb, *Views Diverge on How to Recast Fannie, Freddie*, WASH. POST, Dec. 22, 2008, at D01 ("Fannie, Freddie and government agencies are funding nearly all of the nation's home loans."); see also Stephen Labaton, *All Grown Up and, Some Say, Unneeded*, N.Y. TIMES, Sept. 14, 2008, at 4 (discussing the GSEs roles in mortgage finance and critics' concerns about their structures).

153. See Jody Shenn & James Tyson, *Fannie, Freddie May Enrich Shareholders in Subprime's Shakeout*, BLOOMBERG.COM, June 5, 2007, <http://www.bloomberg.com/apps/news?pid=20601103&sid=axfeEvVeLwww&refer=news> ("Fannie Mae and Freddie Mac lost market share starting in 2002 as the housing boom began and the companies became mired in accounting scandals."); Julia Patterson Forrester, *Fannie Mae/Freddie Mac Uniform Mortgage Instruments: The Forgotten Benefit to Homeowners*, 72 MO. L. REV. 1077, 1082-83 (2007).

154. See FREDDIE MAC, INFORMATION STATEMENT AND ANNUAL REPORT TO STOCKHOLDERS 2 ("At December 31, 2007, our total mortgage portfolio, which includes our retained portfolio and credit guarantee portfolio, was \$2.1 trillion, while the total U.S. residential mortgage debt outstanding, which includes single-family and multifamily loans, was approximately \$11.8 trillion."); FED. NAT'L MORTGAGE ASS'N, QUARTERLY REPORT (Form 10-Q), at 10 (Mar. 31, 2008) (stating that as of December 31, 2007, Fannie Mae had \$2.9 trillion in total mortgage credit outstanding, or approximately 24.5%.); GINNIE MAE, ANNUAL REPORT 2007, at 7 ("The increase in FHA loan volume and demand for highly secure, liquid securities has helped to boost issuance of Ginnie Mae MBS and subsequently, Ginnie Mae's outstanding portfolio. Issuance increased 4.3 percent during FY 2007 with an ending outstanding portfolio balance of \$427.6 billion, up from \$410 billion in FY 2006.")

155. *The Role of Fannie Mae and Freddie Mac in the Financial Crisis: Hearing Before the H. Comm. on Oversight and Government Reform*, 111th Cong. (2008) (statement of Rep. Paul Kanjorski), available at <http://oversight.house.gov/documents/20081209115538.pdf>.

156. See, e.g., Brescia, *supra* note 108, at 272 (analyzing responses to the subprime mortgage crisis by looking at its causes, including government deregulation that led to innovations in mortgage products).

157. See *Turmoil in the U.S. Credit Markets: The Genesis of the Current Economic Crisis: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs*, 111th Cong. 11, at 29 (2008) (testimony of Eric Stein, Senior Vice President, Center for Responsible Lending) (documenting subprime loans as 7.2% of the market of mortgage originations in 2001, and 20.1% of the market in 2006).

of risky mortgages being offered to less creditworthy borrowers: only 16% were fixed-rate mortgages, 40% were 30-year ARMs, 17% were interest-only loans, 19% were 40-year ARMs, and 8% were balloon loans.<sup>158</sup> In addition, between 2000 and 2005, the number of subprime loans made without full documentation of the borrowers' income, assets or employment climbed from 26% of subprime mortgages in 2000 and by 2005 the portion had grown to 44%.<sup>159</sup>

Subprime mortgages were targeted at communities of color.<sup>160</sup> At the height of the subprime lending activity in 2006, white borrowers took on 71% of new mortgages and 56% of all subprime mortgages, African-American borrowers were responsible for 10% of new mortgage originations and 19% of new subprime mortgages and Hispanic people represented 14% of new borrowers and 20% of new subprime mortgage originations.<sup>161</sup>

#### F. *The Community Reinvestment Act and the Subprime Bubble*

For nearly 50 years, the dual system of federal financing and state regulation of residential home mortgage markets remained in place and was relatively successful in providing access to capital and protecting borrowers from abusive lending practices.<sup>162</sup> However, this system was less than successful in providing mortgage financing to urban homeowners and to racial minorities.<sup>163</sup> The effort to address this pattern of the withholding of credit from communities of color, referred to as "red-

158. *Id.* at 11.

159. *Id.*

160. Brescia, *supra* note 108, at 272; Susan E. Hauser, *Predatory Lending, Passive Judicial Activism, and the Duty to Decide*, 86 N.C. L. REV. 1501, 1509–10 (2008) (citing the marketing of predatory lenders toward groups they perceive as financially unsophisticated, including low-income and minority borrowers, as an additional abuse).

161. Bob Tedeschi, *Subprime Loans' Wide Reach*, N.Y. TIMES, Aug. 3, 2008, at RE10.

Whites made up 71 percent of the borrower population in 2006 and received 56 percent of the subprime loans originated that year. Blacks, meanwhile, made up 10 percent of the loan pool, yet received 19 percent of the subprime loans. Hispanics constituted 14 percent of the borrower community and received 20 percent of the subprime loans.

*Id.*

162. See Rashmi Dyal-Chand, *From Status to Contract: Evolving Paradigms for Regulating Consumer Credit*, 73 TENN. L. REV. 303, 307–16 (2006) (discussing the development of current mortgage law as a balance between state regulation to protect borrowers from lenders with more bargaining power and knowledge and federal deregulation to increase access to credit); Rayth T. Myers, Comment, *Foreclosing on the Subprime Loan Crisis: Why Current Regulations are Flawed and What is Needed to Stop Another Crisis From Occurring*, 87 OR. L. REV. 311, 317–18 (2008) (discussing the securitization of mortgage loans in recent years and its role in the increase in subprime lending and the decrease in the effectiveness of previous state regulations).

163. See generally Lloyd T. Wilson, Jr., *Effecting Responsibility in the Mortgage Broker-Borrower Relationship: A Role for Agency Principles in Predatory Lending Regulation*, 73 U. CIN. L. REV. 1471, 1474 n.11 (2005) (discussing the targeting of potential borrowers based on demographic data); Julia Patterson Forrester, *Mortgaging the American Dream: A Critical Evaluation of the Federal Government's Promotion of Home Equity Financing*, 69 TUL. L. REV. 373, 388–89 (1995) ("Those most often affected [by predatory lenders] are minorities, the elderly, and the inner-city and rural poor.").

lining,” was one area of increased consumer protection in the mortgage markets during the period after 1975.<sup>164</sup>

Congress passed the Community Reinvestment Act (CRA) in 1977, requiring insured commercial banks and thrifts “to demonstrate that their deposit facilities serve the convenience and needs of the communities in which they are chartered to do business.”<sup>165</sup> These needs include access to credit and personal banking services.<sup>166</sup> CRA required financial institutions’ federal regulators to, as part of periodic examinations, “assess the institution’s record of meeting the credit needs of its entire community, including low- and moderate-income neighborhoods, consistent with the safe and sound operation of such institution.”<sup>167</sup> The assessment must be considered by the regulator as part of the determination whether to authorize an institution’s application to open a new branch.<sup>168</sup> CRA did not create quotas requiring financial institutions to provide services to underserved communities but, instead, created incentives to do so.<sup>169</sup>

Enforcement of the Community Reinvestment Act intensified in the 1990s under the Clinton administration.<sup>170</sup> In 1999, the Gramm-Leach-Bliley Act (GLBA) added a provision that prohibited banks that did not comply with the diversity standards imposed by the Federal Reserve under CRA from converting from bank holding companies into financial holding companies.<sup>171</sup> As discussed in more detail below, in order for banking holding companies to take advantage of the ability under

164. Wilson, *supra* note 163, at 1487 (explaining that the Community Reinvestment Act of 1977 was used to address “the problem of ‘redlining’ by encouraging lenders to make capital available throughout the lender’s community rather than concentrating loans only in ‘desirable’ locations”).

165. 12 U.S.C. § 2901(a)(1) (2006).

166. *Id.* § 2901(a)(2).

167. *Id.* § 2903(a)(1).

168. *Id.* § 2903(a)(2).

169. Thomas W. Beetham, Note, *The Community Reinvestment Act and Internet Banks: Redefining the Community*, 39 B.C. L. REV. 911, 915 (1998) (stating that Congress attempted to balance the bank’s obligation to ensure community access with its need for independence to select profitable investment opportunities through the CRA by not requiring banks to meet quotas, instead encouraging them to consider all income groups in the region).

The CRA emphasizes that banking institutions fulfill their CRA obligations within the framework of safe and sound operation. Although CRA performance evaluations have become more quantitative since regulatory changes in 1995, stressing actual performance rather than documented efforts to serve their community’s credit needs, the CRA does not stipulate minimum targets or even goals for lending, service or investments. At the same time it is fair to say that the primary focus of the CRA evaluations is the number and dollar amount of lending to lower-income borrowers or areas. However, the agencies instruct examiners to determine an institution’s capacity to extend credit to lower-income groups and assess local economic and market conditions that might affect the income and geographic distribution of their lending and to judge their performance in this context.

Memorandum from Glenn Canner & Neil Bhutta, Bd. of Governors of the Fed. Reserve Sys., Div. of Research and Statistics, to Sandra Braunstein, Dir., Consumer & Community Affairs Div. 2 (Nov. 21, 2008) (available at [http://www.federalreserve.gov/newsevents/speech/20081203\\_analysis.pdf](http://www.federalreserve.gov/newsevents/speech/20081203_analysis.pdf)).

170. William H. Simon, *The Community Economic Development Movement*, 2002 WIS. L. REV. 377, 400 (stating that the Community Reinvestment Act was strengthened by new regulations in 1995 and the Clinton administration’s Community Development Banking and Financial Institutions Act of 1994).

171. 12 U.S.C. § 1843(l)(2) (2006).

GLBA to engage in non-banking financial activities including insurance or securities underwriting they were required to convert to financial holding companies by registering with the Federal Reserve.<sup>172</sup>

Some have argued that the Community Reinvestment Act was a major contributor to the mortgage crisis because it compelled loans to persons with poor credit histories.<sup>173</sup> However, according to Randall Kroszner, Federal Reserve Board Governor,

*[S]tudies [prepared by the Fed for Congress] found that lending to lower-income individuals and communities has been nearly as profitable and performed similarly to other types of lending done by CRA-covered institutions. Thus, the long-term evidence shows that the CRA has not pushed banks into extending loans that perform out of line with their traditional businesses. Rather, the law has encouraged banks to be aware of lending opportunities in all segments of their local communities as well as to learn how to undertake such lending in a safe and sound manner.*<sup>174</sup>

Even more pertinently, the vast majority of risky subprime loans that are the focus of the crisis were underwritten between 2004 and 2007, more than ten years after the CRA was strengthened in 1995 and more than five years after the Gramm-Leach-Bliley provisions governing bank holding company conversions.<sup>175</sup>

Finally, non-bank lending institutions, such as mortgage brokers, are not covered by CRA.<sup>176</sup> When the subprime mortgage originations peaked in 2006, only 6% of these mortgages were made by institutions covered by CRA.<sup>177</sup> A study by Federal Reserve researchers concluded that “[t]aken together, the available evidence to date does not lend support to the argument that the CRA is a root cause of the subprime crisis.”<sup>178</sup>

172. *Id.* § 1843(l)(1).

173. See, e.g., L. Gordon Crovitz, *Information Age: When Even Good News Worsens a Panic*, WALL ST. J., Nov. 24, 2008, at A17 (alleging Congress’ policies of making mortgages too available proximately caused the credit collapse); Martin Samchalk, Letter to the Editor, *Bad Apples are Bad in Any Package*, WALL ST. J., Oct. 13, 2008, at A18 (stating that the CRA “forced bad lending practices on our economy”).

174. Randall S. Kroszner, Governor, Fed. Reserve Board, Remarks at the Confronting Concentrated Poverty Policy Forum: The Community Reinvestment Act and the Recent Mortgage Crisis (Dec. 3, 2008) (available at <http://www.federalreserve.gov/newsevents/speech/kroszner20081203a.htm>).

175. Memorandum from Canner & Bhutta, *supra* note 169, at 2.

176. See 12 U.S.C. § 2902 (2006); see also Memorandum from Canner & Bhutta, *supra* note 169, at 7, for a comparison between the role of CRA covered entities and independent mortgage companies in subprime lending at its peak.

177. Memorandum from Canner & Bhutta, *supra* note 169, at 3 (citing that 2006 Home Mortgage Disclosure Act data indicated only 6% of all subprime loans in 2006 were made by CRA-covered institutions to lower-income borrowers or neighborhoods).

178. See *id.* at 6. The Federal Reserve used “higher-priced loans” as a proxy for subprime mortgages. *Id.* at 3.



G. *Conclusions*

Deregulation was offered as a solution to the strains placed on regulated mortgage markets by instability in the larger financial system in the 1970s. Despite efforts to rebuild the regulatory system surrounding the mortgage finance system through FIRREA after the S&L crisis, it is clear that the long-run trend since the 1970s has been to weaken mortgage regulation. This long-term weakening accelerated dramatically after 2003 in an environment of very cheap credit and a federal government uninterested in consumer protection regulation. For a time, the mortgage bubble that resulted substituted for a healthy labor market as a source of increasing aggregate demand in the U.S. economy.<sup>179</sup> However, mortgage markets did not exist during this period in isolation. Mortgage markets grew at an enormous pace due to their being able to access capital flows available due to a broader deregulatory trend in the capital markets writ large.<sup>180</sup> But that very deregulatory trend had in it the seeds of a further crisis of opacity that returned to haunt both the mortgage markets and the larger economy in the crisis of 2007–08.<sup>181</sup>

III. FINANCIAL MARKET DEREGULATION AND THE CREATION OF THE SHADOW FINANCIAL SYSTEM

A. *Early Stages of Deregulation*

Deregulation affected nearly all areas of the financial markets during the period from the 1980's through 2008.<sup>182</sup> While it is outside the scope of this article to discuss all areas of deregulation, several areas particularly facilitated the flow of funds into mortgage-related assets and led to opacity throughout the financial system.<sup>183</sup>

The histories of the weakening of mortgage regulation and the emergence of the shadow financial system begin at the same point—with the passage of DIDMCA, whose mortgage-related implications were discussed above. DIDMCA established

179. See 155 CONG. REC. H512 (daily ed. Jan. 26, 2009) (statement of Rep. Kucinich) (“As wages were stagnant, the Fed intentionally created the housing bubble to lure people on to debt treadmills to keep the economy afloat. Americans own less and less of their homes. And the belief that asset inflation separate from wages is real wealth is ludicrous.”).

180. *Id.*

181. William Pfaff, *Market Speculation Fuels Inflation*, CHARLESTON GAZETTE, Jan. 14, 2008, at 4A (“[I]n important respects, deregulation and globalization have undermined valid markets. To function, a real market depends on reliable information, and among the characteristics of recent developments have been a multiplication of derivatives and a practice of ‘securitization’ that have greatly increased the opacity of markets.”).

182. For a comprehensive discussion of deregulation from 1975 through 2000, see Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975–2000: Competition, Consolidation, and Increased Risks*, 2002 U. ILL. L. REV. 215.

183. *Id.*

the Depository Institutions Deregulation Committee to phase out interest rate controls on non-checking account bank deposits over a six-year period.<sup>184</sup>

The purposes of DIDMCA included making the cost of capital more equal among depository institutions, leveling the playing field among bank and non-bank financial services providers and allowing consumers access to higher interest savings, and improving public access to financial services and encouraging competition among financial services providers.<sup>185</sup> One of the deregulatory measures used to accomplish this was the removal of caps on interest rates banks could pay on deposits.<sup>186</sup>

Since the late 1970s and early 1980s, there has been a marked flow of funds away from checking and savings accounts, traditionally the only FDIC-insured accounts, and into riskier, higher yielding parts of the financial markets.<sup>187</sup> This began with the rapid rise of interest rates in the 1970s when individuals began moving their savings into higher yielding money market mutual funds.<sup>188</sup>

Traditionally, banks have served as the providers of capital for companies that could not access the public equity and debt markets.<sup>189</sup> The commercial paper market, however, began to erode banks' prevalence in the corporate loan market in the 1970s.<sup>190</sup> From 1970 to 1995 the commercial paper market grew from one-twentieth the size of the commercial bank loan market to one-fifth of the size.<sup>191</sup>

184. Depository Institutions Deregulation Act of 1980 § 204, 12 U.S.C. § 3503 (expired in 1986). Section 204 authorized a phase-out of rate limitations and a gradual maximum rate increase. *Id.* Sections which implemented the Depository Institutions Deregulations Committee expired in 1986. *Id.* §§ 3501–3509.

185. Elijah Brewer III, *The Depository Institutions Deregulation and Monetary Control Act of 1980: Landmark Financial Legislation for the Eighties*, FED. RES. BANK OF CHICAGO ECON. PERSPECTIVES, Sept. 1980, at 3, 3–4, available at [http://www.chicagofed.org/publications/economicperspectives/1980/ep\\_sep\\_oct1980\\_part1\\_brewer.pdf](http://www.chicagofed.org/publications/economicperspectives/1980/ep_sep_oct1980_part1_brewer.pdf).

186. *Id.*

187. Wilmarth, *supra* note 182, at 239–41.

188. *Id.* at 239.

189. *Id.* at 227–28.

190. *Id.* at 231.

191. *Id.* (citing Franklin R. Edwards & Frederic S. Mishkin, *The Decline of Traditional Banking: Implications for Financial Stability and Regulatory Policy*, FED. RES. BANK OF N.Y., ECON. POL'Y REV., July 1995, at 27, 31). The preference for nonbank lending was also visible in the growth of the junk-bond markets in the late 1980s and, again, in the period from 2002–2007. *Id.* at 231–32; see Tim Weithers, *Credit Derivatives, Macro Risks, and Systemic Risks*, FED. RES. BANK OF ATLANTA, ECON. REV., Oct. 2007, at 43, 51 (stating that record low default rates from 2005–2006 encouraged investment in junk bonds); see also Tom Petrino, *Investing: Trashed Junk Bonds Making a Comeback*, L.A. TIMES, Sept. 28, 2007, at 1 (stating that default rates of junk bonds were at a two decade low following a record high in 2002). By the late 1980s, around 20% or \$200 billion of all corporate debt issuances were below investment grade. Wilmarth, *supra* note 182, at 232 (citing Lawrence M. Benveniste et al., *The Failure of Drexel Burnham Lambert: Evidence on the Implications for Commercial Banks*, 3 J. FIN. INTERMEDIATION 104, 107 (1993)). New issues and outstanding junk bonds contracted after the leveraged buyout bust in the late 1980s and then started to grow again in conjunction with the tech bubble of the late 1990s and reached \$600 billion in outstanding junk bonds in April 2000. *Id.* Consumer lending exhibited a similar move away from regulated banking institutions and by 2004, 54% of household debt was held by nonbank lenders, including 39% by nonbank mortgage or real estate lenders. *Id.* at 238.

When interest rates began to rise in the late 1970s and early 1980s, depositors took money out of savings accounts and invested in money market funds, which are mutual funds that invest in short-term bonds and provide significant liquidity to investors.<sup>192</sup> Investors viewed money market funds as a high-yield alternative to a savings account.<sup>193</sup>

### B. Securitization

Securitization was pioneered by Freddie Mac as a way to increase capital available to finance fixed rate mortgages in the secondary market and provide investors with a moderate-yield, home mortgage backed bond.<sup>194</sup> It later became the tool utilized by lending institutions to access seemingly limitless amounts of capital to finance loans that were too risky for regulated institutions to hold on their balance sheets.<sup>195</sup>

The GSEs pioneered securitization as a means of improving liquidity of mortgage assets and increasing the flow of capital into the markets. Until 1984, however, private financiers were largely prevented from purchasing or owning mortgage-related securities.<sup>196</sup> Congress passed the Secondary Mortgage Market Enhancement Act of 1984 (SMMEA) to allow private financial institutions to invest in MBS.<sup>197</sup> SMMEA included provisions that preempted state laws that would have prevented state regulated banks from investing in privately issued MBS and prohibiting states from regulating private MBS issuances.<sup>198</sup> This set the stage for a dramatic increase in both the supply and demand for securitized debt. In the mid-1980s, private issuers began securitizing non-mortgage assets to create securities backed by car loans, credit card receivables, corporate loans and other types of assets.<sup>199</sup>

Most securitizations meet the definition of an “investment company” under the Investment Company Act of 1940 and would be regulated like mutual funds if they did not find ways to operate under exceptions to the Act.<sup>200</sup> The Investment Company Act of 1940 (“1940 Act”) was enacted to address the differences between direct

192. U.S. SEC. AND EXCH. COMM’N, DIVISION OF INVESTMENT MANAGEMENT, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION 506 (1992) [hereinafter PROTECTING INVESTORS] (explaining how the SEC facilitated the growth of money market funds through the passage of exemptive orders in the 1970s that allowed them circumvent valuation requirements that traditional investment companies, such as mutual funds, must fulfill).

193. Wilmarth, *supra* note 182, at 239–41.

194. Engel & McCoy, *supra* note 136, at 1273–74.

195. *Id.*

196. See generally PROTECTING INVESTORS, *supra* note 192, at 9 (noting that Congress passed the Secondary Mortgage Market Enhancement Act of 1984 “to expand the participation of the private sector” in the secondary mortgage-backed securities market).

197. Secondary Mortgage Market Enhancement Act of 1984, Pub. L. No. 98-440, 98 Stat. 1689 (codified as amended at 15 U.S.C. § 77r-1).

198. PROTECTING INVESTORS, *supra* note 192, at 9–10.

199. See *id.* at 11–13.

200. See *id.* at 66–68.

investments in public companies and participation in pooled investment vehicles.<sup>201</sup> The 1940 Act requires that these pooled investment vehicles be subject to enhanced regulation.<sup>202</sup>

In order to facilitate the issuance of securitized debt, the SEC issued a rule in connection with SMMEA that relaxed the registration requirements applicable to these issuances, generically called asset-backed securities (ABS).<sup>203</sup> In 1992, the SEC expanded its 1984 rulemaking and relaxed registration requirements for non-mortgage ABS and exempted many ABS transactions from 1940 Act registration.<sup>204</sup> ABS are also exempt from anti-fraud provisions of Sarbanes-Oxley that require chief executive officers and chief financial officers of public companies to file attestations with the commission certifying the accuracy of their financial reports.<sup>205</sup> The Commission also issued no-action letters exempting large portions of the securitization market from registration requirements and issued a rule in 2005 codifying these decisions.<sup>206</sup>

The market for securitized debt stimulated the U.S. bond market to nearly double in the last eight years, from \$17.20 trillion at the end of 2000 to \$33.18

201. See *After Blackstone: Should Small Investors be Exposed to Risks of Hedge Funds?: Hearing Before the H. Subcomm. on Domestic Policy, Comm. on Oversight*, 110th Cong. (2007) (testimony of Joseph Borg, President of the Board of Directors of the North American Securities Administrators Association).

202. See *id.*

203. SEC Shelf Registration Rule, 17 C.F.R. § 230.415 (2008).

204. See generally Simplification of Registration Procedures for Primary Securities Offerings, Exchange Act Release No. 33-6964, 34-31345, 57 Fed. Reg. 48,970 (Oct. 29, 1992) (adopting amendments to substantially simplify the securities registration process).

205. See generally Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Securities Act Release No. 22-8238, Exchange Act Release No. 47,986, Investment Company Act Release No. 26,068, Sarbanes-Oxley Act File No. S7-40-02, 68 Fed. Reg. 36,636 (June 18, 2003) (adopting reporting requirement rules pursuant to Section 404 of Sarbanes Oxley Act of 2002 concerning management's report on the company's internal control over financial reporting).

206. Asset-Backed Securities, Securities Act Release No. 8518, Exchange Act No. 50,905, Sarbanes-Oxley Act File No. S7-21-04, 70 Fed. Reg. 1506 (Jan. 7, 2005).

[W]e recognize that securitization is playing an increasingly important role in the evolution of the fixed income financial markets. Our staff has attempted to accommodate the different nature of ABS and evolving business practices, while reducing unnecessary or impractical compliance burdens, through its numerous no-action and interpretive positions. However, the accumulated informal guidance, while helpful to some ABS transactions, has diminished the transparency of applicable requirements because an ABS registrant or investor seeking to understand the applicable requirements must review and assimilate a large body of no-action letters and other staff positions. This time-consuming practice decreases efficiency and transparency and leads to uncertainty and common problems. Even before we issued the proposals, many issuers, investors and other market participants had requested a defined set of regulatory requirements for guidance. Commenters on the proposals expressed universal support for a separate framework for the registration and reporting of ABS. Staff reviews of filings provide further evidence that many compliance issues may be mitigated and potential issues avoided through clearer and more transparent regulatory requirements. Recent market events involving distressed transactions also have highlighted the need for improved disclosures as well as a renewed attention on servicing practices.

*Id.*

trillion in the third quarter of 2008.<sup>207</sup> The types of debt pooled and sold to investors has expanded to include auto loans, credit card receivables, student loans, commercial real estate loans, and corporate loans.<sup>208</sup> While growth in the debt markets between 2000 and 2008 was led by mortgage-related debt, which exploded by more than 250% during this period, corporate debt was not far behind, having grown 182%.<sup>209</sup>

Securitization of loans to companies purchased in leveraged buyouts provided the necessary capital to finance a boom in leveraged buyouts that coincided roughly with the boom in the subprime mortgage market.<sup>210</sup> U.S. and European leveraged buyout funds, or “private equity”, raised \$250 billion in 2005 alone, five times LBO fund raising 10 years earlier.<sup>211</sup> According to some estimates, in 2006 new LBO transactions valued at around \$500 billion were completed.<sup>212</sup>

As securitization evolved to include riskier types of loans, the structure of securitizations changed with the intent of continuing to provide highly rated securities that institutional investors, especially money market funds and pension funds, would purchase as well as riskier, higher yielding securities to appeal to investors with more appetite for risk.<sup>213</sup> This was accomplished by creating multi-tiered capital structures so that investors that owned interests in different tiers of the structure had different rights to cash flows generated by the pool. In most circumstances, this

207. Securities Industry and Financial Markets Ass’n, Outstanding U.S. Bond Market Debt, [http://www.sifma.org/research/pdf/Overall\\_Outstanding.pdf](http://www.sifma.org/research/pdf/Overall_Outstanding.pdf) (last visited Feb. 22, 2009).

208. See Maria Chan, *US Worries May Slow Banks’ Profit Growth*, S. CHINA MORNING POST, Mar. 31, 2008, at 4 (“Collateralised debt obligations are pools of mortgages, corporate loans or commercial and property loans sliced into bonds with varying credit ratings and maturities.”); see also Jenny Anderson & Heather Timmons, *Why a U.S. Subprime Mortgage Crisis Is Felt Around the World*, N.Y. TIMES, Aug. 31, 2007, at C1 (stating that banks sell asset-backed securities comprised of pooled mortgages, student loans, auto loans, credit card receivables, and other income-producing assets).

209. Securities Industry and Financial Markets Ass’n, *supra* note 207.

210. COMM. ON THE GLOBAL FIN. SYS., BANK FOR INT’L SETTLEMENTS, PRIVATE EQUITY AND LEVERAGED FINANCE MARKETS 1 (2008), available at <http://www.bis.org/publ/cgfs30.pdf>.

The amount of leveraged loans and highyield bonds outstanding tripled between 1999 and 2007. A large part of leveraged debt issuance has been used to finance leveraged buyout (LBO) deals, which are dominated by private equity transactions. Favourable global economic and financial market conditions, high investor risk appetite and financial innovation were important drivers of rapid market growth.

*Id.*

211. JEAN HELWEGE & FRANK PACKER, BANK FOR INT’L SETTLEMENTS, PRIVATE MATTERS 1 (2008), available at <http://www.bis.org/publ/work266.pdf>.

212. *Id.*

213. COMM. ON THE GLOBAL FIN. SYS., *supra* note 210, at 1.

The landscape of the leveraged finance market has changed substantially in the current decade. Leveraged loan issuance has grown much more rapidly in recent years than issuance of high-yield bonds. At the same time, institutional investors have replaced banks as the main investors. Several related developments have contributed to these shifts in market structure: the emergence of collateralised loan obligation (CLO) vehicles as loan securitisers and intermediaries; growing ratings coverage of loans, which attracted institutional investors; increased secondary market trading of leveraged loans; and a shift in bank business models from “buy and hold” to “originate to distribute” (OTD).

*Id.*

meant that the highest level or tranche had the senior-most interest in the pool and was paid the lowest interest rate and the junior-most interest holder was paid the highest interest rate.<sup>214</sup>

The end result was that investors owned varying interests in diverse pools of corporate and personal loans that made it difficult, if not impossible, for even the most sophisticated investors to perform proper due diligence.<sup>215</sup> Rating agencies claimed to provide the due diligence necessary to give investors comfort that the securities were safe and secure and the ratings allowed investors, chasing higher yielding assets for their money market funds or pension funds, to buy trillions of dollars of the senior-most tranches of these securities.<sup>216</sup>

### C. *Shadow Financial Markets*

In order for financiers to continue to sell these securities en masse there had to be a market for the most junior tranches.<sup>217</sup> Hedge funds—opaque and unregulated investment pools only saleable to wealthy investors—provided this market.<sup>218</sup>

One of the ways that owners of more junior interests in securitized debt attempt to shield themselves from the risk that the borrowers whose loans are held in the securitized pool will default is through the purchase of unregulated insurance contracts called “credit default swaps” (CDS).<sup>219</sup> According to data from Bank of America published in March 2007, banks and brokers are the largest participants in the CDS market, accounting for 33% of buyers and 39% of sellers.<sup>220</sup> Hedge funds

214. See Ingo Fender & Janet Mitchell, *Structured Finance: Complexity, Risk and the Use of Ratings*, BIS Q. REV., June 2005, at 69, 76, available at [http://www.bis.org/publ/qtrpdf/r\\_qt0506.htm](http://www.bis.org/publ/qtrpdf/r_qt0506.htm) (noting that under priority ordering, credit support “means the most senior claims are expected to be insulated” from most “default risk of the asset pool”). See generally *id.* at 67–78 (discussing the risk properties of structured finance instruments and the underlying asset pools).

215. MARGUERITTE HARLOW, A REVIEW OF THE MONGOLIAN PRIMARY MORTGAGE MARKET 12–13 (2007) (noting that the “more heterogenous the terms and documentation is of a portfolio of loans, the greater the cost of due diligence”).

216. See *The Role of Credit Rating Agencies in the Structured Finance Market: Hearing Before the H. Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises, Comm. on Financial Services* 110th Cong. 8 (2007) (testimony of J. Kyle Bass, Managing Partner, Hayman Capital) (explaining that NRSROs have become “de facto regulatory bodies,” particularly in relation to money market funds and pension funds due to legal requirements that require them to invest in bonds that the NRSROs have given high ratings).

217. Committee on the Global Financial System, *Private Equity and Leveraged Finance Markets* 26–31 (Bank for Int’l. Settlements, CGFS Working Group Paper No. 30, 2008), available at <http://www.bis.org/publ/cgfs30.pdf?noframes=1>.

218. *Id.* at 27. See Appendix G, *infra*, for the investor share of securitization products.

219. Bruce E. Kayle, *The Federal Income Tax Treatment of Credit Derivative Transactions*, in *TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS 2007*, at 573, 579–80 (PLI Tax Law & Estate Planning, Course Handbook Series No. 792, 2007) (providing a detailed explanation of credit default swaps).

220. Darrell Duffie, *Innovations in Credit Risk Transfer: Implications for Financial Stability* 5 (Bank for Int’l Settlements, BIS Working Paper No. 255, 2008), available at <http://www.bis.org/publ/work255.pdf?noframes=1>.

are the second most active participants and account for an estimated 31% of CDS purchasers and 28% of CDS sellers.<sup>221</sup>

Until Congress passed the Commodity Futures Modernization Act (CFMA) in 2000, CDS and other derivatives contracts were subject to the Commodities Exchange Act and regulated by the Commodities Futures Trading Commission.<sup>222</sup> CFMA, however, removed CDS from regulators' purview, allowing the market to grow to as large as \$58 trillion by some estimates.<sup>223</sup> The CDS markets became the unseen glue that linked the world's financial institutions to one another and, according to some reports it was Bear Stearns' activities in the CDS markets that led regulators to believe it was too interconnected to fail.<sup>224</sup>

All of these factors have contributed to the creation of a huge system of lending, borrowing, securities underwriting, and insurance underwriting that exists completely outside the purview of regulators.<sup>225</sup> The lending, mostly done by unregulated mortgage brokers, the borrowers themselves, the pooling, the entities that bought these assets, and the insurers are, to a large extent, opaque.<sup>226</sup> Neither regulators nor the public have access to sufficient information to assess the risk within these assets or counterparty exposure arising from participating in these opaque markets.<sup>227</sup>

Leveraged buyout funds, largely unregulated pooled investment vehicles that buy operating companies using small amounts of equity and large amounts of debt, have become a large source of securitized debt.<sup>228</sup> The value of outstanding LBO loans is probably much higher than the value of outstanding subprime mortgages, which was \$1.3 trillion in 2007, because banks and other lenders provided \$1.1

221. *Id.*

222. See Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763 (explaining that the purpose of the Commodity Futures Modernization Act of 2000 is to eliminate certain regulations for commodity futures exchanges and streamline the legal framework for trading in futures and derivatives).

223. *Testimony Concerning Turmoil in U.S. Credit Markets: Recent Actions Regarding Government Sponsored Entities, Investment Banks and Other Financial Institutions: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 110th Cong. 1-2 (2008) (statement of Christopher Cox, Chairman, SEC), available at <http://www.sec.gov/news/testimony/2008/ts092308cc.htm> (remarking that the credit default swap market is an unregulated \$58 trillion market which is completely opaque).

224. *The Economic Outlook: Hearing Before the J. Economic Comm.*, 110th Cong. 2 (2008) (statement of Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys.), available at <http://www.federalreserve.gov/newsevents/testimony/bernanke20080402a.htm>. "Our financial system is extremely complex and interconnected, and Bear Stearns participated extensively in a range of critical markets. . . . Given the current exceptional pressures on the global economy and financial system, the damage caused by a default by Bear Stearns could have been severe and extremely difficult to contain. Moreover, the adverse effects would not have been confined to the financial system but would have been felt broadly in the real economy through its effects on asset values and credit availability." *Id.* at 2-3.

225. See Paul McCulley, *Teton Reflections*, PIMCO: GLOBAL CENTRAL BANK FOCUS, Aug./Sept. 2007, <http://www.pimco.com/LeftNav/Featured+Market+Commentary/FF/2007/GCBF+August-+September+2007.htm>.

226. Nouriel Roubini, *The Rising Risk of a Systemic Financial Meltdown: The Twelve Steps to Financial Disaster*, RGE MONITOR, Feb. 5, 2008, [http://media.rgemonitor.com/papers/0/12\\_steps\\_NR](http://media.rgemonitor.com/papers/0/12_steps_NR).

227. *Id.*

228. U.S. GOV'T ACCOUNTABILITY OFFICE, PRIVATE EQUITY: RECENT GROWTH IN LEVERAGED BUYOUTS EXPOSED RISKS THAT WARRANT CONTINUED ATTENTION 7, 10 (2008).

trillion in debt financing for LBOs between 2005 and 2007 alone.<sup>229</sup> Despite their size, neither companies owned by LBO funds nor their investors are subject to any oversight.<sup>230</sup> When a public company is purchased in a leveraged buyout, it is taken private and generally stops filing regular reports with the SEC that are required of public companies by the securities laws.<sup>231</sup>

Leveraged buyout funds and hedge funds, like ABS issuing entities, meet the definition of investment companies under the 1940 Act.<sup>232</sup> Hedge funds and private equity funds are private investment companies that are exempt from regulation as investment companies under section 3(c)(1) of the Act, which exempt funds that are not sold to the general public and have fewer than 100 shareholders, or section 3(c)(7) because they are not sold to the general public and their shareholders meet certain requirements.<sup>233</sup> The interests hedge funds and private equity funds sell to investors are generally exempt from registration, and offered as private placements under Regulation D of the Securities Act of 1933.<sup>234</sup> This means that hedge funds and private equity funds do not provide transparency to regulators or investors in

229. *Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 110th Cong. (2007) (testimony of Emory W. Rushton, Senior Deputy Comptroller and Chief National Bank Examiner, Office of the Comptroller of the Currency).

230. See Gregory J. Schwartz, *Regulation of Leveraged Buyouts to Protect the Public Shareholder and Enhance the Corporate Image*, 35 CATH. U. L. REV. 489, 492–93 (1986) (explaining that neither state common law nor federal securities law have developed to the extent necessary to adequately and fairly regulate LBOs in the emerging shadow markets, which, in turn, causes a situation where there is a risk of the so-called “control group” of the leveraged company focusing on personal interests rather than the interests of all shareholders with little oversight in their path).

231. See 15 U.S.C. §§ 77a–77z-1 (2006).

232. 15 U.S.C. § 80a-3(a)(1). An investment company is any issuer which:

- (A) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities;
- (B) is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificate outstanding; or
- (C) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer’s total assets (exclusive of Government securities and cash items) on an unconsolidated basis.

*Id.*

233. 15 U.S.C. § 80a-3(c)(1) & (7). In 2004 the SEC passed a rule requiring hedge fund managers to register under the Investment Advisers Act. The rule would have given the SEC limited authority to oversee the activities of most hedge fund investment managers. See Registration of Certain Hedge Fund Advisers, Investment Advisers Release No. 2333, 69 Fed. Reg. 72,054 (Dec. 10, 2004) (codified at 17 C.F.R. pts. 275, 279 (2006)). The rule was invalidated by the D.C. Circuit Court in 2006. *Goldstein v. S.E.C.*, 451 F.3d 873, 884 (D.C. Cir. 2006); see also Recent Cases, *Administrative Law—Judicial Review of Agency Rulemaking—District of Columbia Circuit Vacates Securities and Exchange Commission’s “Hedge Fund Rule.”*—*Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006), 120 HARV. L. REV. 1394 (2007).

234. SEC Regulation D, 17 C.F.R. §§ 230.501–508 (2008). Regulation D provides exemptions in which the offer and sale of securities can be made without registration with the Securities and Exchange Commission because, among other requirements, the sale was made to an accredited investor in a private placement. See *id.*



the way public companies or mutual funds do.<sup>235</sup> These exemptions for hedge funds and private equity funds meant that some of the largest issuers of debt that was pooled and sold to investors and some of the largest purchasers of this debt were completely outside of regulators' purview.

#### D. *The End of Glass-Steagall*

Meanwhile, the Federal Reserve had begun chipping away at the Glass-Steagall Act's separation of banking and securities activities in 1987.<sup>236</sup> Over 10 years, the Fed issued a series of regulations that allowed bank subsidiaries to underwrite and deal corporate debt and equity securities.<sup>237</sup> In 1987, bank subsidiaries were limited to transactions in commercial paper and a small range of securities as long as these activities did not account for more than 5% of the subsidiary's gross revenues.<sup>238</sup> By 1997, however, the Fed had broadened the types of securities transactions that could be undertaken by bank subsidiaries, the revenue limit was increased to 25% of the subsidiaries' gross revenues and rules had been lifted that barred banks from marketing the securities services provided by their subsidiaries.<sup>239</sup> This allowed regulated commercial banks to enter the securitization markets in a substantial way and also exposed regulated financial institutions to these unregulated loan pools.<sup>240</sup>

The final nail in the coffin for the Glass-Steagall Act's prohibition of providing banking and securities services within a single entity came in 1998 when the Federal Reserve authorized the merger of Citicorp, a commercial bank, with Travelers Group, Inc., an insurance company that had securities firm Salomon Smith Barney as a subsidiary, to form Citigroup, the first universal bank in the U.S.<sup>241</sup> Citigroup has become the bank that has received the largest amount of TARP bailout funds including \$45 billion in preferred stock purchases and a \$300 billion asset guarantee.<sup>242</sup>

235. Roel C. Campos, Comm'r, Sec. and Exch. Comm'n, Remarks Before the Hedge Fund Institutional Forum Corporate Funds Roundtable (Mar. 5, 2007) (stating that hedge funds are not typically registered with the SEC; therefore, the information available in the public domain regarding hedge funds is minimal).

236. Nicole Fradette et al., *Regulatory Reform in Transition: The Dismantling of the Glass-Steagall Act*, 47 ADMIN. L. REV. 545, 546, 552, 567–68 (1995) (explaining that the Federal Reserve along with the court system acted in a manner which eventually caused the weakening of the Glass-Steagall Act's separation of commercial and investment banking).

237. Wilmarth, *supra* note 182, at 319 (discussing the Federal Reserve Board's continued relaxation of the Glass-Steagall Act in 1996 through 1997 when the Board allowed section 20 subsidiaries to engage in securities transactions so long as these transactions did not rise above 25% of the bank's gross revenues).

238. *Id.*

239. *Id.*

240. *Id.* at 319–20. The enlargement of the section 20 limits initiated a trend in which investment banks no longer dominated the public offerings market as commercial banks continued to purchase section 20 subsidiaries and expanded themselves into the securities market. *Id.*

241. Legal Developments, *Order Approving Formation of a Bank Holding Company and Notice to Engage in Nonbanking Activities*, 84 FED. RES. BULL. 985 (1998) (describing an order by the Federal Reserve Board approving of the merger of Travelers Group, Inc. and Citicorp Insurance Company).

242. See CONGRESSIONAL OVERSIGHT PANEL, ACCOUNTABILITY FOR THE TROUBLED ASSET RELIEF PROGRAM (Jan. 9, 2009).

In 1999, Congress passed the Gramm-Leach-Bliley Act (GLBA), which repealed restrictions on financial institutions' business operations that had been in place since 1933 when Congress passed the Glass-Steagall Act.<sup>243</sup> Glass-Steagall was intended to address conflicts of interest and systemic risk issues that arose from the operation of commercial and investment banking within the same firm.<sup>244</sup> GLBA dismantled the barriers between commercial and investment banking, insurance, and mortgage lending.<sup>245</sup> Once commercial banks were permitted to enter the riskier and more lucrative businesses previously reserved for investment banks, which did not take FDIC-insured consumer deposits, bank holding companies shifted away from consumer lending. As a result, unregulated mortgage brokers moved into the home mortgage business.<sup>246</sup>

#### IV. CONCLUSION

This article has attempted to survey the history of deregulation since 1970 in the areas of labor markets, housing finance, and the broader capital markets. We have sought to suggest how weakened labor market regulation creates an environment of downward pressure on aggregate demand. In such an environment, where credit is very cheap, asset-based lending becomes an attractive source of alternative consumer demand. Such a strategy cannot work in a world of financial transparency and comprehensive regulation of leverage and credit quality.<sup>247</sup> Thus another set of pressures comes into being, pressures to create regulatory-free spaces where leverage can be incurred and real risks taken without the expensive backup of capital reserves or the necessity of market actors telling anyone else what they are actually doing. Of course, in a downturn, these shadow markets act as procyclical accelerants to an economic downturn.

The challenge facing policymakers and regulators is how to rebuild an overall system of economic regulation in a global context that can once again channel capital to productive uses without the levels of volatility characteristic of recent years.

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243. Gramm-Leach-Bliley Act, Pub L. No. 106-102, 113 Stat. 1338, § 101 (1999) (repealing §§ 20 & 32 of the Glass-Steagall Act).

244. Anna Jackson Holly, Comment, *The Gramm-Leach-Bliley Act: Protection of Consumers or Excuse to Avoid Discovery?*, 36 CUMB. L. REV. 615, 633-34 (2006). The Glass-Steagall Act was originally intended to prevent commercial banks from engaging in securities transactions by maintaining a wall between commercial banks and investment banks. *Id.* at 634.

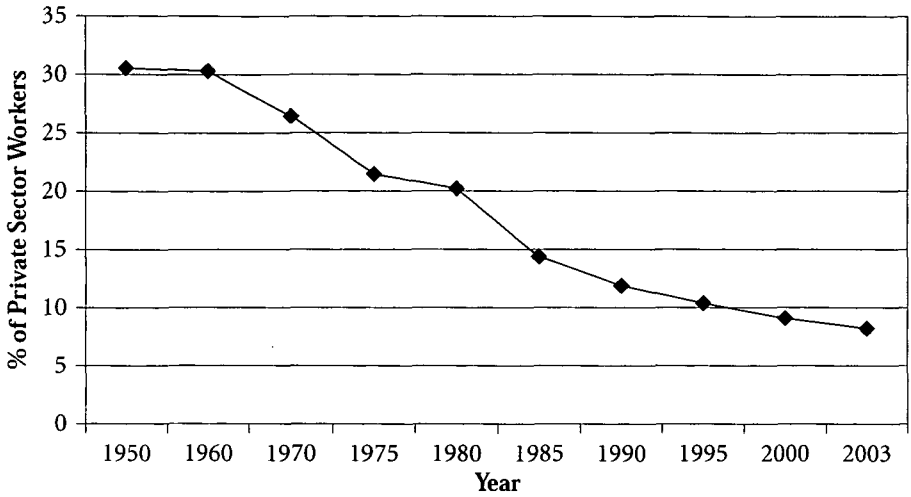
245. See Pub L. No. 106-101, 113 Stat. 1341 (repealing the separation between commercial and investment banks required by the Glass-Steagall Act).

246. Terry Carter, *How Lawyers Enabled the Meltdown: And How They Might Have Prevented It*, A.B.A. J., Jan. 2009, at 34, 35. The Gramm-Leach-Bliley Act of 1999 not only affected commercial bank involvement in the securities markets, it also caused commercial banks to move away from the home loan market in an effort to further involve themselves in "mergers and acquisitions, retail brokering, and the underwriting of securities based on subprime loans and collateralized debt obligations." *Id.* This left "home loan due diligence to largely unregulated brokers[.]" *Id.* See Appendix H, *infra*, for the effect of regulation on the American financial system.

247. See Fannie Mae, Introduction, *supra* note 130, at 1.

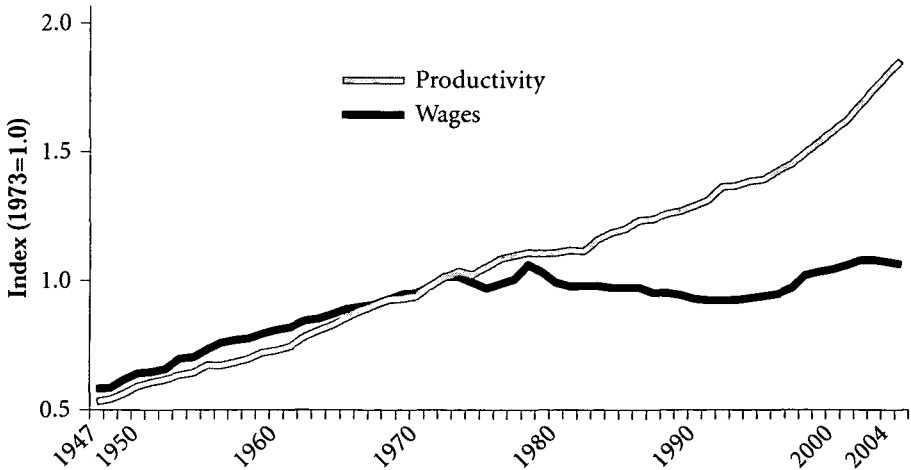
THE LEGACY OF DEREGULATION AND THE FINANCIAL CRISIS

APPENDIX A—PRIVATE SECTOR UNION DENSITY



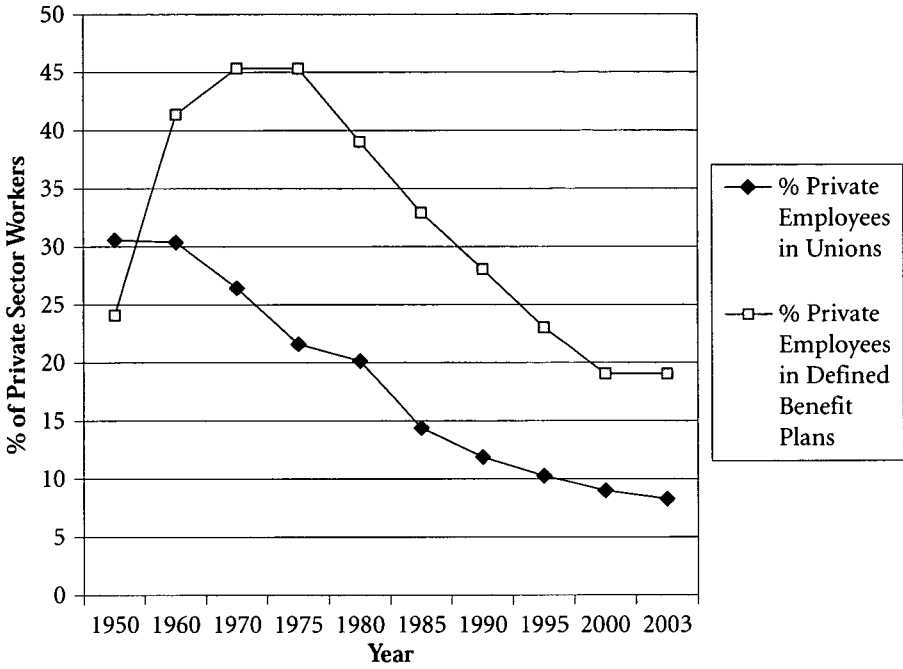
Source: Economic Policy Institute.

APPENDIX B—WAGES AND PRODUCTIVITY



Source: Economic Policy Institute.

APPENDIX C—PENSION COVERAGE AND UNION DENSITY

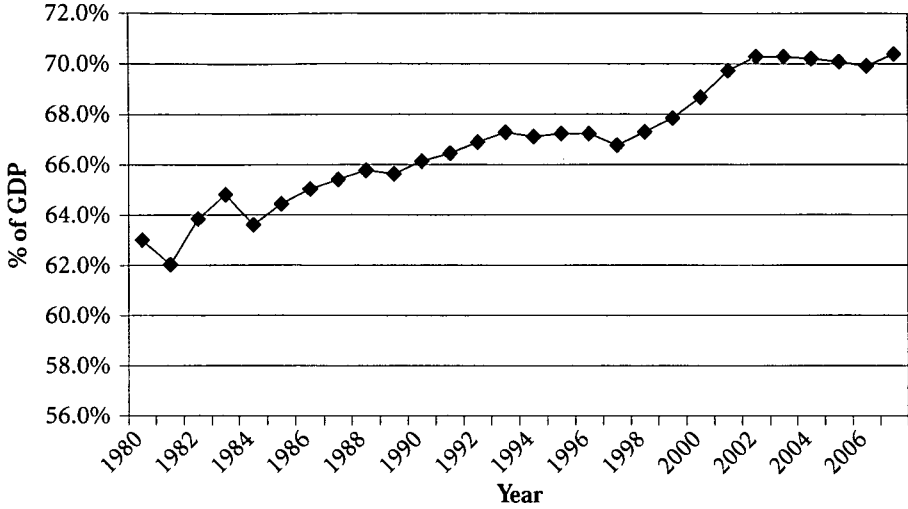


Source: Economic Policy Institute

THE LEGACY OF DEREGULATION AND THE FINANCIAL CRISIS

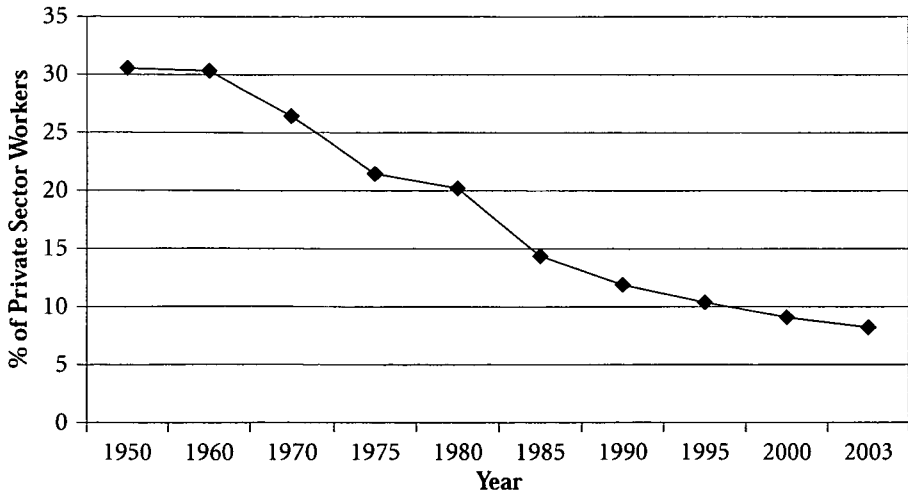
APPENDIX D—CONSUMER SPENDING AND UNION DENSITY

CONSUMER SPENDING AS A PERCENTAGE OF GROSS DOMESTIC PRODUCT



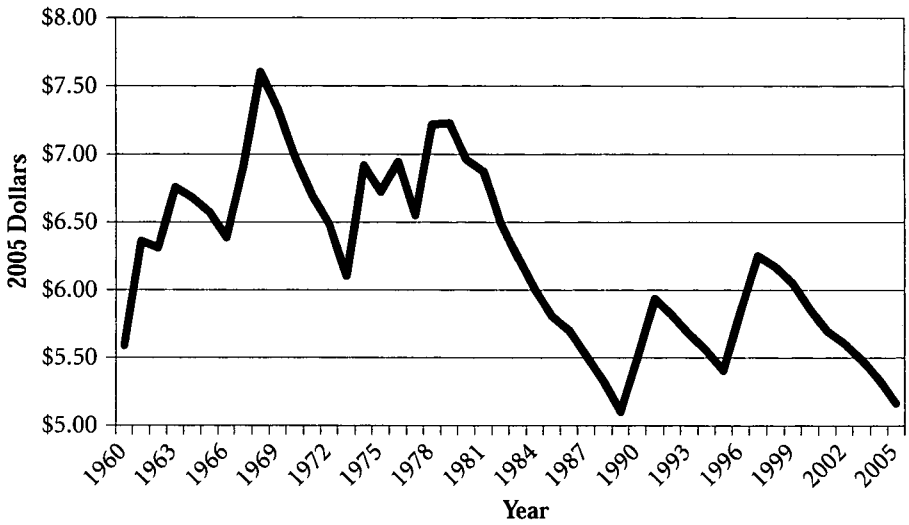
Source: Bureau of Economic Analysis, U.S. Department of Commerce

PRIVATE SECTOR UNION DENSITY



Source: Economic Policy Institute

APPENDIX E—REAL DOLLAR VALUE OF THE MINIMUM WAGE

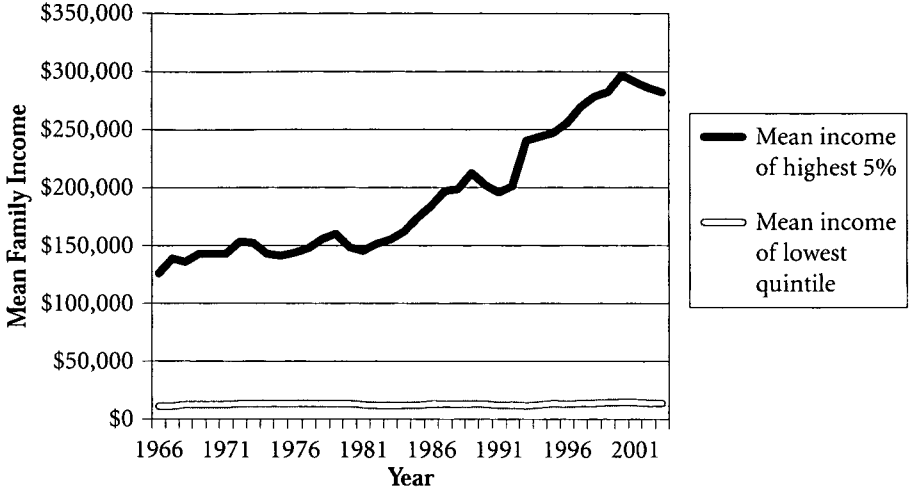


Source: Economic Policy Institute

THE LEGACY OF DEREGULATION AND THE FINANCIAL CRISIS

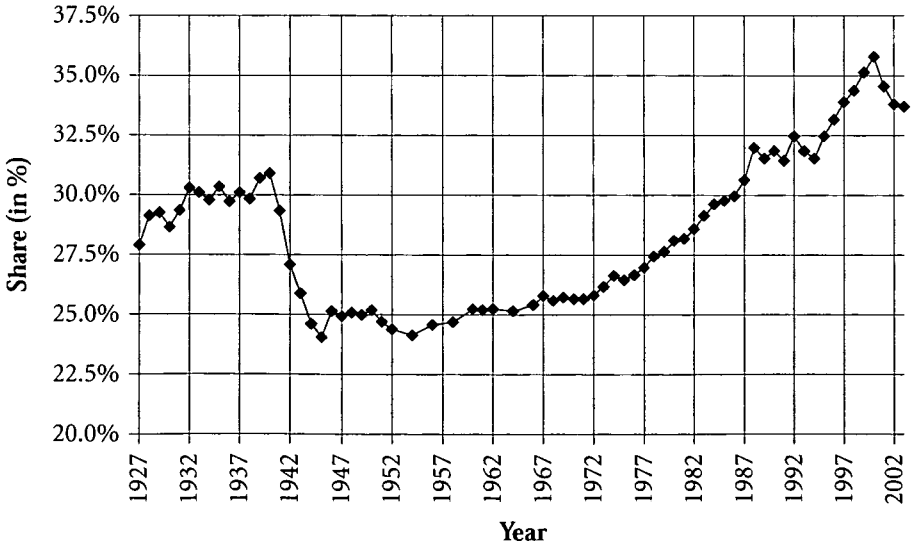
APPENDIX F—GROWTH IN INEQUALITY

MEAN INCOME IN 2003 DOLLARS



Source: Economic Policy Institute

THE TOP DECILE WAGE INCOME SHARE, 1927–2002

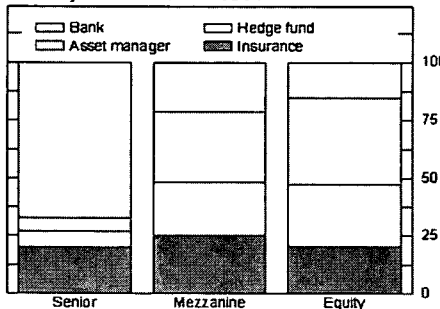


Source: Emmanuel Saez

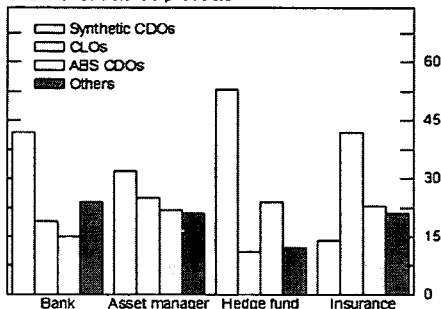
APPENDIX G—INVESTOR SHARE OF SECURITISATION PRODUCTS<sup>248</sup>

INVESTOR SHARE OF SECURITISATION PRODUCTS IN 2007

Who buys what tranche in CLOs<sup>1</sup>



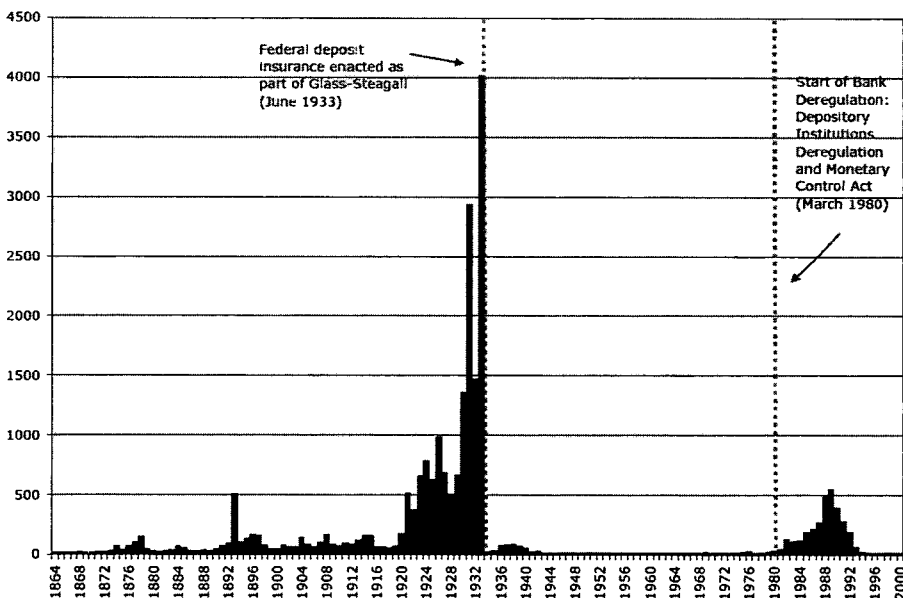
Share of structured products<sup>1</sup>



<sup>1</sup> In per cent.

Source: Citigroup.

APPENDIX H—EFFECT OF REGULATION ON THE AMERICAN FINANCIAL SYSTEM



Source: David Moss, "An Ounce of Prevention: The Power of Sound Risk Management in Stabilizing the American Financial System." 2009.

248. Committee on the Global Financial System, *supra* note 210, at 28.