A Simple Explanation of Some Legal and Economic Aspects of the

Financial Meltdowns of Banks

By Bruce D. Fisher

The mortgage meltdown and associated financial crisis have given rise to many questions about the United States financial system. Many have sought a nontechnical explanation of several legal and economic aspects associated with the banking meltdown. This article contains some answers to these questions. It covers several ideas such as fractional reserves, mortgage securitization, "fair value accounting," and the Glass-Steagall Act. Each played a role in the current financial crisis, which is of particular significance to Michigan residents, given the collapse of consumer finance so important in creating the market for consumer goods like automobiles manufactured by Michigan corporations.

Fractional Reserves in a Period of Financial Crisis

Basic courses on money and banking teach us that banks do not keep all of their depositors' deposits on hand (that is, on the premises). The assumption is that all depositors will not show up the same day and seek to withdraw all of their deposits. Indeed, banks have only a small fraction of their depositors' money on hand at any given time. This assumption has proved true and reflects the idea that only "fractional reserves"—meaning only a small part of depositors' money—are ever on hand at any given moment. This relationship enables banks to invest these deposits into mortgages and other assets to earn income at a rate beyond that paid to depositors. This is no revelation and has been the case for many years.

In the United States, depositors are protected under this scheme by Federal Depository Insurance Corporation (FDIC) depository insurance, recently increased up to $250,000 (and in some cases more). Thus, should the unthinkable happen and depositors demand back their entire deposits in one fell swoop, the money would be there, provided by the monetary authorities (the FDIC or the Federal Reserve). Where would the monetary authorities come up with all this money? They would probably transfer money to the distressed bank from the monetary authorities themselves or, if the problem were broad enough, have to print the money if the "run on the bank" materialized.

Have runs on the bank occurred in recent times? Yes. Recall the case of Northern Rock Bank in the United Kingdom, as well as cases involving several banks in the United States. When one sees the lines of depositors at "stressed" banks such as occurred at Northern Rock or some United States domestic banks, one wonders if these people had ever heard of insurance on deposits. All federally chartered banks must be FDIC insured, and state banks that are FDIC members (not all are) are also FDIC insured. Assuming the banks in question were part of a deposit insurance scheme, there would have been no need for depositors to line up for hours, as the monetary authorities would ultimately have "made good" on their deposits up to the amount of any cap. Perhaps the depositors lined up had more on deposit than the amount of the insurance cap, however; this would be a rational reason to line up early in a run on the bank.

"Fair Value Accounting" and Its Contribution to the Financial Crisis

"Fair value accounting" refers to the periodic "revaluation" of assets on an organization's (often a bank's) balance sheet. It is the result of Financial Accounting Standards Board Standard No. 157,[1] which mandates such periodic revaluation for certain institutions. Some of the assets on the books of financial institutions are home mortgages and mortgage-backed securities. Mortgages are security devices that give creditors a claim on a particular asset of the borrower so that in the event the borrower defaults, the mortgage holder can seize the particular asset, sell it, and take the proceeds to pay off the balance the debtor owes the creditor.

In the not too distant past, say before 1980, most home mortgages were held by individual banks in the debtors' communities and were eventually paid off by the borrower directly to the lending institution. About 1980, however, securitization of mortgages developed. The term "securitization of mortgages" refers to pools of mortgages in which excellent credit risks (those with no defaults likely before or at mortgage maturity) are combined with other mortgages—good-credit-risk mortgages, average-credit-risk mortgages, below-average-credit-risk mortgages, and high-risk-of-default mortgages. This mortgage pool is then "sliced and diced"—that is, some of the excellent mortgages (or parts of them) are combined with parts of the other categories of mortgages, so that a resulting "mortgage security" results. This mortgage security composed of bits and pieces of many individual mortgages is sold on the market.

A moment's reflection reveals potential weaknesses with such securitized mortgages: In the event of default, where is the property that will be seized to pay off the debt the mortgage secures? The doorknob of the house that represented the mortgaged property that was sliced and diced? One begins to see the fragility—indeed, illusory nature—of the collateral securing these debts. Also, where is the debt to which the mortgage was related? Is it still associated with that mortgage? Entirely or just in part? Recall that the debt that the sliced-and-diced mortgage secures was also sliced and diced and combined with other debt to make up the security. One hopes that the debt and the associated mortgage that that debt secures are still associated with each other in whole or in part. Assuming they are still associated with each other, a further question remains: Are they whole, or is part of the debt/mortgage in one security and another part of the same debt/mortgage part of another security? One begins to see what a tangled brew is potentially involved in mortgage securitizations and why such assets are considered "toxic."

One should not, however, be totally critical of mortgage securitization because there were socially laudable objectives in these inventions of investment bankers, who possibly thought, How can we get low-income, high-risk-of-defaulting borrowers into their own homes so they can realize the American dream? The answer of the inventive, innovative investment bankers was the securitized mortgage. Blending many mortgages of varying risk characteristics (excellent to bad) and then slicing and dicing them into securities sold to the investment community generated the funds to loan these high-risk borrowers. As with most derivative securities, these were not considered "securities" for purposes of registration under either the Securities and Exchange Commission or Commodity Futures Trading Commission (CFTC) on the assumption[2] that the buyers of such derivatives (often banks or pension funds) would know what risks they were assuming and that even "light" regulation of them would impede the flow of the capital markets.

Fast Facts:

All federally chartered banks and state banks that are Federal Depository Insurance Corporation (FDIC) members (not all are) are FDIC insured.

Fair value accounting and mortgage securitization could be seen as contributors to the financial crisis.

Repeal of the Glass-Steagall Act was probably a mistake.

Thus, one might argue that there is nothing sinister about securitized mortgages if the buyer understands what he/she/it is buying. To realize full value on such an investment, the investor might have to hold the securitized instrument until the underlying debts mature (which could be 20 to 30 years, depending on the length of the underlying mortgages). Thus, one might assert that the securitized mortgages are quite illiquid because who would want to wait 20 to 30 years to get the principal back?

Mention should also be made of a now defunct proposal (reportedly supported by CitiCorp)[3] that would have conferred authority on the bankruptcy courts to extend or lower interest rates or otherwise rewrite the terms of the debts/mortgages to enhance the probability that the underlying mortgages would be repaid. This proposal was supported by consumer groups and United States Senator Richard J. Durbin of Illinois. It was opposed by holders of securitized debt on the grounds that it would further depress the value of the securitized debts, thereby further impairing the capital of the banks that often are holders of such assets. The American Securitization Forum and the Securities Industry and Financial Markets Association denounced the proposal as having a negative effect on mortgage-backed securities.[4] Because of such strong opposition, this proposal was defeated, and bankruptcy judges still do not have authority to rewrite individual home mortgages. Other efforts to confer such authority on bankruptcy judges are raised from time to time, but without success thus far.

The Repeal of the Glass-Steagall Act and Its Contribution to the Current Financial Crisis

No discussion of the present financial crisis would be complete without mentioning the repeal of the Glass-Steagall Act.[5] This statute was enacted in the 1930s and essentially recognized that there should be a legal separation between commercial banks and investment banks. Commercial banks are thought of as the traditional banks that take depositors' money and make loans to consumers, homeowners, and businesses. Such banks should be run conservatively and not take unnecessary chances with their depositors' money. On the other hand, investment banks serve the entrepreneurial community by putting their own money at risk in new ventures and businesses with a more speculative outlook. Investment banks and their stakeholders are by nature risk-takers. The Glass-Steagall Act recognized and mandated that these two types of banks be kept separate, given the lessons learned during the Great Depression when depositors' money was lost as commercial banks entered the investment banking realm and were wiped out, leaving depositors empty-handed.

In 1999, a federal statute called the Gramm-Leach-Bliley Act[6] was enacted. In part, it repealed the Glass-Steagall Act amid a "new vision" that the markets know best: People can look out after themselves, and they do not need "big government" or "regulators" looking out for them. When one regulator, Brooksley Born, then chair of the CFTC, attempted to promulgate even a mild "transparency regulation" for derivatives trading in 1999, her efforts were summarily quashed by three powerful men perceived to be wiser in the ways of the markets[7]—then United States Treasury Secretary Robert Rubin, then Deputy Treasury Secretary Lawrence Summers, and Federal Reserve Chairman Alan Greenspan—on the grounds that her proposal would jeopardize the capital markets. The result of their efforts could be our current financial crisis.

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Repealing the Glass-Steagall Act was probably a major mistake and undoubtedly contributed to today's financial crisis by depriving the markets of information necessary to assess the nature and inherent risk in the derivative securities traded.

Conclusion

The current financial crisis has yet to play out in the United States and world economies. Europe clearly blames the United States for originating "toxic" assets (mortgage-backed securities) that formed the foundation for this crisis and selling them to European (and other) banks and financial institutions. When the true nature of those assets became clear, they declined severely in value, the banks' lending capacity contracted, and the current financial crisis ensued.

One could argue that "market deregulation" in 1999 laid the foundation for the current need for heightened regulation and even the calls for "bank nationalization" that we hear today. The unprecedented lending of governmental funds to distressed banks and other institutions, not only in the United States but in Europe and even Asia, is now being supported by some of the same persons who advocated laissez faire markets in the 1990s. As Santayana observed, those who cannot remember the past are condemned to repeat it.[8] ■

Bruce D. Fisher is professor of business law at the University of Tennessee. He is also visiting professor of law at HEC School of Management, Paris, France. He has authored 13 books and over 60 academic articles in such journals as the Rutgers Law Review, *the* University of Cincinnati Law Review, *the* Administrative Law Review, *the* Wall Street Journal, *the* New York State Bar Journal, *and the* Michigan Bar Journal.

FOOTNOTES

1. Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 157 (issued September 2006 for financial statements issued for fiscal years beginning after November 15, 2007, and interim reports within those fiscal years), available at <http://www.fasb.org/st/status/statpg157.shtml> (accessed February 21, 2010).
2. See Beattie & Politi, *"I made a mistake" admits Greenspan,* Financial Times, October 24, 2008, at 1.
3. See van Duyn, *U.S. bankruptcy code bill rattles the MBS market,* Financial Times, January 13, 2009, at 24.
4. *Id.*
5. PL 73-66, 48 Stat 162.
6. PL 106-102, 113 Stat 1338.
7. See Goodman, *The Reckoning: Taking a Hard Look at the Greenspan Legacy,* NY Times, October 8, 2008, at A1.
8. Santayana, *Life of Reason* (1905), v 1, ch 12, in The Oxford Dictionary of Quotations (6th ed), p 666 (Oxford University Press, 2004).