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The subprime crisis: U.S. regulatory responses and lessons learned

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Market fluctuations arising from the subprime meltdown, and in particular the collapse of Bear Stearns, have led to increased calls for legislative and regulatory action to address the various causes of the crisis. This paper summarizes U.S. regulatory developments that have responded to these events, and looks to potential future legislative and regulatory developments that may be expected to address the weaknesses that the crisis has revealed.

I. FEDERAL RESERVE RESPONSE TO THE BEAR COLLAPSE: A TRIGGERING EVENT FOR SUBSEQUENT REGULATORY ACTIVITY

A) The so-called "bailout of Bear": the Federal Reserve agreed to provide a $30 billion non-recourse loan to JP Morgan to permit it to acquire Bear Stearns, secured only by Bear's less liquid assets. Equity holders received $10/share, up from the original $2 deal but still substantially below the share price immediately preceding the collapse. Bear's debt was guaranteed 100% — in effect, a bailout of Bear's market counterparties.

B) The potential moral hazard: firms that are too large, or too connected, to be permitted to fail may be viewed as having a government guarantee behind their contracts, and thus may present incentives for riskier counterparty behavior.

C) There is also considerable fear that the central bank's interventions may make it more difficult for it to maintain its independence.

II. FEDERAL RESERVE AUCTION FACILITIES AND DISCOUNT WINDOW ACCESS

A) New Fed lending facilities: In response to growing concerns regarding market stability, the Federal Reserve established the Term Auction facility in December for cash loans to commercial banks, the Term Securities Lending Facility in March for loans of Treasury securities to securities dealers, and the Primary Dealer Credit Facility in March for cash loans to securities dealers.

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B) Through the Primary Dealer Credit Facility, the Federal Reserve has opened its "discount window"[1] to non-bank securities firms for the first time since the 1930s; this facility therefore has been the subject of considerable attention.

1. The Facility provides overnight funding to primary dealers in exchange for a broad range of investment-grade collateral.[2]

2. It is available only to primary dealers — the twenty government securities dealers that trade U.S. Government and agency securities with the Federal Reserve Bank of New York.[3]

3. Authority: Section 13(3) of the Federal Reserve Act authorizes the Reserve Banks to lend, in the form of discounts, to any individual, partnership, or corporation in "unusual and exigent circumstances" upon the affirmative vote of five of the seven members of the Board of Governors of the Federal Reserve and a finding by the lending Reserve Bank that the borrower is

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[1] The Federal Reserve Banks lend funds to depository institutions through the "discount window." All depository institutions that maintain transaction accounts or non-personal time deposits subject to reserve requirements are entitled to borrow at the window. These institutions include commercial banks, thrift institutions, and U.S. branches and agencies of foreign banks. Reserve Banks have three standard lending programs for depository institutions — primary credit, secondary credit and seasonal credit. Primary credit is short-term (typically overnight) and made to depository institutions with strong financial positions and ample capital; secondary credit is offered at a higher rate to institutions that do not qualify for primary credit; and seasonal credit is provided to small- and mid-sized depository institutions, typically small agricultural banks, able to demonstrate a clear pattern of recurring intra-year fluctuations in funding needs.

[2] Eligible collateral include all collateral eligible for tri-party repurchase agreements arranged by the Federal Reserve Open Market Trading Desk, as well as all investment-grade corporate securities, municipal securities, mortgage-backed securities, and asset-backed securities for which a price is available. Primary Dealer Credit Facility – Frequently Asked Questions, available at *http://www.newyorkfed.org-/markets/pdcf_faq.html*.

The New York Reserve Bank's website explains how the Facility differs from discount window lending to depository institutions: "Currently, the primary credit facility offers overnight as well as term funding for up to 90 calendar days at the primary credit rate secured by discount window collateral to eligible depository institutions. The PDCF, by contrast, is an overnight facility that will be available to primary dealers (rather than depository institutions) for a period of 120 business days. The PDCF is subject to a frequency-of-usage fee, and the loans will be secured by a different basket of securities than those eligible for pledging at the discount window; in particular, only priced securities will be accepted in the PDCF." *Id.*

[3] The primary dealers are: BNP Paribas Securities Corp., Banc of America Securities LLC, Barclays Capital Inc., Bear, Stearns & Co., Inc., Cantor Fitzgerald & Co., Citigroup Global Markets Inc., Countrywide Securities Corporation, Credit Suisse Securities (USA) LLC, Daiwa Securities America Inc., Deutsche Bank Securities Inc., Dresdner Kleinwort Wasserstein Securities LLC., Goldman, Sachs & Co., Greenwich Capital Markets, Inc., HSBC Securities (USA) Inc., J. P. Morgan Securities Inc., Lehman Brothers Inc., Merrill Lynch Government Securities Inc., Mizuho Securities USA Inc., Morgan Stanley & Co. Incorporated, and UBS Securities LLC. *See http://www.newyorkfed.org/markets/pridealers_current.html*.

unable to secure adequate credit accommodations elsewhere.[4] Board regulations add the requirement that the Reserve Bank find that "the failure to make the loan would adversely affect the economy."[5]

4. The Facility is expected to expire in mid-September.[6]

5. Investment banks have reportedly reduced their reliance on the discount window, from a high of $28.8 billion on March 19 to $10.125 billion as of May 28.[7]

C) Additional regulation is likely to be implemented if investment banks are to continue to receive discount window access.

1. At present, the Federal Reserve has no authority to regulate investment banks that do not have a commercial bank in their corporate family. As a result of firms accessing the discount window, however, New York Fed examiners are working with SEC staff inside major investment banks, examining those banks that have used their access to the window. The SEC and the Federal Reserve are drafting a formal memorandum of understanding that would establish how the agencies will share information on investment banks.[8]

III. TREASURY BLUEPRINT

A) The U.S. Department of Treasury, as part of its efforts to improve the competitiveness of the US capital markets, began a study of regulatory structure in March 2007 and issued a "Blueprint for a Modernized Financial Regulatory Structure" on March 31, 2008, recommending substantial regulatory reform (also called the "Paulson plan," after Secretary of Treasury Hank Paulson). **For**

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4 12 U.S.C. § 343.

5 12 C.F.R. § 201.4(d).

6 The PDCF could be extended under the provision cited above, or pursuant to the Fed's authority to provide non-banks more regular, non-emergency access to the discount window; the latter, however, would require a change to the Board's regulations and such credit would be required to be secured only by U.S. Government and agency securities.

7 Steven Sloan, *Fed Meeting Topic: Investment Banks,* American Banker, Jun. 3, 2008.

8 *See, e.g.,* Neil Irwin, *Fed Keeps Watch on Wall St. — From the Inside,* Washington Post, May 27, 2008, at D1; Bill McConnell, *Current, ex-SEC officials defend agency,* Daily Deal, May 8, 2008.

details on the Blueprint, see Appendix A to this document and WilmerHale's Securities/Financial Institutions Briefing Series, "Treasury Department's Proposed Overhaul of the Financial Regulatory Structure: A Look at the Blueprint and a Look Ahead" (April 2008).

B) The Blueprint is broad in scope and proposes more fundamental structural reforms than narrowly targeted responses to the recent crisis. Nonetheless, some of its suggestions for reform may be viewed as appropriate responses to the problems observed in the subprime crisis, in particular the idea of a market oversight regulator.

C) The plan is a statement by the Department of Treasury, not an official Bush administration position. The administration and Congress are not expected to take action on the overall proposal in the near future. (Movement toward regulatory reform may be expected to regain momentum after the November presidential election.)

D) There is considerable opposition to certain parts of the plan. For example, Office of Thrift Supervision ("OTS") Director John Reich has been outspoken in his criticism of the plan, which would eliminate his agency, and has instead suggested that OTS be given jurisdiction over all aspects of the U.S. mortgage industry.[9] Small banks and credit unions (fearing that a single banking regulator will favor large banks or that traditional banks), and state prosecutors (who fear weak federal oversight) also oppose the plan.[10] The debate over the creation of an optional federal charter for insurance companies has been ongoing for years.

IV. CREDIT RATING AGENCIES

A) Background: The SEC became the regulator for credit rating agencies in 2006 with the passage of the Credit Rating Agency Reform Act; prior to that, the agencies were essentially unregulated by the federal government. A formal regulatory program was established with the promulgation of SEC rules in June

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9 *See, e.g., U.S. Bank Regulator Calls for OTS Regulation of Mortgage Market,* Dow Jones Capital Markets Report, May 29, 2008.

10 *See, e.g., Lobbyists, Small Banks Attack Plan for Market,* Wall St. J., Apr. 1, 2008, at A1.

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2007.[11] Agencies were required to register in order to become nationally recognized statistical rating organizations ("NRSROs"),[12] and were then subject to SEC examination and enforcement. Seven agencies immediately did so, including those that were most active in rating subprime residential mortgage-backed securities ("RMBS") and collateralized debt obligations ("CDOs").[13]

B) At a Senate Banking Committee hearing in April, the Senate encouraged the SEC to impose tougher regulations on credit rating agencies. Senator Dodd (D-Conn.) suggested that SEC Chairman Cox request new legislative authority.[14]

C) The SEC staff is working on a rule proposal that would require more disclosure and better management of conflicts by credit rating agencies. Potential areas of rulemaking include requirements for enhanced disclosures about ratings performance, requirements to address conflicts of interest, and increased transparency, including enhanced disclosures regarding how NRSROs determine ratings for structured products.[15] The staff is particularly concerned about the practice of "shopping around" to get a desirable rating. Separately, the staff is reviewing potential changes to other requirements (*e.g.*, Rule 15c3-3, the "Customer Protection Rule") to reduce dependence on triple-A rated status.[16] A rule proposal is expected to be issued the week of June 9, 2008.[17]

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11 *See* Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 55857, 72 Fed. Reg. 116 (Jun. 18, 2007), available at *http://www.sec.gov/ rules/final/2007/34-55857fr.pdf.*

12 The broker-dealer net capital rule requires broker-dealers to maintain a certain level of capital and allows them to apply lower deductions, or "haircuts," for classes of securities that are rated highly by at least two NRSROs. Prior to the SEC's promulgation of rules under the Credit Rating Agency Reform Act, the SEC had not defined the term, but had identified NRSROs through no-action letters. The NRSRO concept also has been imported into other SEC rules; for example, rules under the Investment Company Act of 1940 include the term NRSRO to prescribe the type of securities a money market fund is permitted to hold. Exchange Act Release No. 55231 (Feb. 2, 2007), available at *http://www.sec.gov/rules/proposed/2007/34-55231.pdf.*

13 See Testimony by SEC Chairman Christopher Cox before the U.S. Senate Committee on Banking, Housing and Urban Affairs, Apr. 22, 2008.

14 Floyd Norris, *Where the Fingers Are Pointing,* N.Y. Times, Apr. 28, 2008.

15 See Testimony by SEC Chairman Christopher Cox, supra n.13.

16 Informal statement by Michael Macchiaroli, Associate Director of the SEC's Division of Trading and Markets.

17 Jesse Westbrook, *SEC May Ban Moody's, S&P From Structured Finance Consulting,* Bloomberg, June 9, 2008, available at *http://www.bloomberg.com/apps/news?pid=20601087&sid=aREApKiIb.pY&refer=home#.*

D) In the meantime, the SEC staff has been conducting examinations of agencies to determine whether they diverged from their procedures in order to publish higher ratings for complex financial products linked to MBSs.

E) On June 6, New York State Attorney General Andrew Cuomo announced an agreement with the three principal credit rating agencies in the U.S. RMBS market — Standard & Poor's, Moody's Investors Service, Inc., and Fitch, Inc. — to implement reforms designed to increase the agencies' independence, require increased due diligence on loan pools, and increase transparency. The agencies reportedly have agreed to:

1. Establish a fee-for-service structure under which they will be compensated regardless of whether an investment bank ultimately selects them to rate a RMBS;

2. Disclose information about all securitizations submitted for their initial review, even if the issuer decided not to use their ratings;

3. Establish criteria for reviewing individual mortgage originators and their origination processes;

4. Develop criteria for the due diligence information investment banks collect on the mortgages underlying a RMBS;

5. Annually review their RMBS businesses to identify practices that could compromise their independent ratings, and remediate any such practices; and

6. Require a series of representations and warranties from investment banks and others regarding the underlying loans.[18]

V. LOOKING FORWARD

A) Additional regulation is certain to come with continued Fed discount window access.

[18] Press Release, Office of the New York State Attorney General Andrew M. Cuomo, Attorney General Cuomo Announces Landmark Reform Agreements with the Nation's Three Principal Credit Rating Agencies (Jun. 5, 2008), available at *http://www.oag.state.ny.us/press/2008/june/june5a_08.html*.

1. Potential areas of new regulation include: additional leverage requirements and potential consequences of failing to meet required leverage ratios, additional risk-based capital requirements (note that broker-dealers are subject to capital requirements now under SEC rules), limits on non-financial commercial activities, limitations on entering into transactions with affiliates.[19]

2. There is disagreement within the Federal Reserve on the best course of action.

   a) Fed Vice Chairman Donald Kohn has suggested that investment banks may get long-term access to Fed liquidity, though at the cost of tougher regulation.[20]

   b) The presidents of several of the regional Federal Reserve Bank[21] have voiced doubts about the wisdom of the Fed's assistance to nonbanks, suggesting that it may weaken market discipline and set the stage for greater risk-taking by market participants.[22]

B) Potential broader reforms

1. Support is growing for the idea of a **market stability regulator.**

   a) Rep. Barney Frank (D-Mass.), Chairman of the House Financial Services Committee has voiced support for the Fed as "financial services system regulator" with power to "assess risk across financial markets regardless of corporate form and to intervene when

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19 It has been reported that investment banks such as Goldman Sachs that have been less affected by the credit crisis are leaning against accepting significant new regulation in exchange for continued access to the Fed's primary dealer credit facility, while banks that have been more affected, such as Lehman Brothers, are more eager to maintain access to the facility even if it means new controls on debt and leverage. Ben White and Francesco Guerrera, *Investment banks split over Fed loan facility,* Financial Times, May 27, 2008.

20 *See, e.g., Window Shopping,* American Banker, Jun. 2, 2008.

21 A network of twelve Federal Reserve Banks (with twenty-five branches) operates under the general supervisory oversight of the Board of Governors of the Federal Reserve System; these are sometimes said to be the operating arms of the central bank.

22 *Two Fed Bank Presidents Warn About Lending to Securities Firms,* Bloomberg News, Jun. 6, 2008.

appropriate."[23] He also has voiced support for reassessing capital requirements for nonbanks.

2. At the same time, there are growing calls for some type of consolidation/restructuring of other aspects of the financial regulatory structure, to address long-standing concerns that the current "patchwork" of regulators leads to a lack of transparency, duplicative regulation, and inefficiency.

3. Many in the securities industry are calling for more **principles-based regulation,** linked with **prudential oversight,** to foster a consultative relationship between regulators and industry participants.

C) Mortgage origination: Debate can be expected regarding the adoption of uniform minimum licensing qualification standards and the creation of a Mortgage Origination Commission. The President's Working Group has recommended nationwide licensing standards for mortgage brokers, and a number of states have committed to participate in a nationwide licensing system/database. In addition, members of Congress may act on the suggestion that the TILA may need to be amended to ensure that it provides adequate protection to consumers.

D) Areas of possible SEC focus

1. SEC-CFTC merger: The SEC can be expected to consider the specific reforms recommended by the Blueprint with an eye towards the continuing debate around a possible merger of the SEC and the CFTC.

2. The SEC may update and streamline its SRO rulemaking process, either pursuant to the Blueprint's suggestions or otherwise.

3. In line with the Blueprint's recommendation that the SEC create a general exemption from registration under the Investment Company Act of 1940 to permit trading of certain new products, rather than continuing to require individual exemptions for such products, an SEC rule proposal is pending to provide a general exemption for ETFs meeting certain criteria.

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23 James Politi, *Frank calls for financial risk regulator*, Financial Times, Mar. 20, 2008; Joe Nocera, *A System Overdue for Reform*, N.Y. Times, Mar. 29, 2008.

4. The SEC may consider whether to recommend to Congress the creation of a new registration category for "global" investment companies. A key issue for such a category will be how to identify as adequate the investor protections applicable to such companies. This issue may intersect with current discussions regarding mutual recognition agreements between US and foreign securities regulators.

E) Insurance: Legislation pending in Congress would create an optional federal charter system for insurers and insurance brokers. The Treasury Blueprint's call for an optional federal insurance charter may spur renewed debate on this proposed legislation, but its interim recommendation for an Office of Insurance Oversight within Treasury is likely to have more traction in the near term.

1. The House Financial Services Subcommittee on Capital Markets and Insurance will hold a June 10 hearing on proposed legislation that would create an office in the Treasury Department to monitor insurance markets (excluding health insurance) by gathering and analyzing publicly available information, and to advise the executive and legislative branches on insurance matters. This would be similar to the Office of Insurance Oversight proposed in Treasury's Blueprint.[24]

F) Centralized clearing for OTC derivatives[25]

1. On June 9, 2008, the New York Federal Reserve Bank met with senior executives of 17 large firms to discuss creating a central system for the trading and settlement of credit derivatives. Attendees included all major investment banks, as well as hedge funds (Citadel Investment Group and BlueMountain Capital Management). This would address the problem of counterparty risk that was highlighted by Bear. It was reported that the

[24] *House Panel Looks at Creating Federal Insurance Expert*, Best's Ins. News (Jun. 4, 2008).

25 While the lack of transparency of complicated OTC derivatives has been the focus of some criticism relating to the subprime crisis, many experts note that OTC derivatives have performed very well in the crisis, and may have been effective hedges against greater losses. *See, e.g.*, Joanne Morrison, *Unregulated OTC derivatives steady in credit crisis*, Reuters, May 6, 2008.

participants at the meeting also agreed to register their trades with a computerized system that would allow for nearly instantaneous recording.[26]

2. The SEC staff was earlier reported to have approached NYSE Euronext about becoming a clearinghouse for information on OTC derivative contracts.[27]

G) What might a new administration do?

1. In a March 27 speech, Senator Obama proposed giving the Federal Reserve supervisory authority over any entity with access to the discount window, extending the Fed's capital and liquidity rules to central banks. Instead of the Fed as market stability regulator, he proposed a public-private commission of experts to look for emerging systemic risks.

2. Senator Obama has advocated U.S. adoption of the Basel II international capital standards for banks.[28]

3. Both Senator McCain and Senator Obama have called for an overhaul of minimum standards for mortgage brokers and lenders.[29] Both have endorsed some consolidation of regulatory agencies as recommended by the Blueprint, and have called for increased market oversight.

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26 Michael M. Grynbaum, *Derivatives Trading is Scrutinized,* N.Y. Times, June 10, 2008; Serena Ng and Emily Barrett, *Fed Turns Focus to Derivatives Market, Wants Improved Infrastructure Soon,* Wall St. J., June 10, 2008, at C1.

27 Joellen Perry, *Global Revamp Urged for the Regulation of Markets,* Wall St. J., Apr. 7, 2008, at A5.

28 Joe Adler, *Obama and Regulation: An Insider's Perspective,* American Banker, Jun. 4, 2008, at 1.

29 Nick Timiraos, *Democrats Respond to Bush Plan,* Wall St. J., Apr. 1, 2008, at A6.