

DERIVATIVES

FINANCIAL PRODUCTS REPORT

UNDERSTANDING AND SOLVING THE TURMOIL IN THE MORTGAGE AND FINANCIAL MARKETS

GIBRAN NICHOLAS

THIS ARTICLE PROVIDES A DIAGNOSIS OF, AND SOME PROPOSED REGULATORY SOLUTIONS FOR, THE CURRENT MORTGAGE AND CREDIT CRISIS.

On March 13, 2008, the President's Working Group (PWG) on Financial Markets¹ issued a report on the causes of the recent financial market turmoil and some proposed solutions. On March 31, 2008, the U.S. Treasury Department released its "Blueprint for a Modernized Financial Regulatory Structure" ("Blueprint") (www.treas.gov/offices/domestic-finance/regulatory-blueprint/) that contains a series of short-, intermediate-, and long-term recommendations for reforming the U.S. regulatory structure. While many of the proposals in both the PWG report and Blueprint are bold and necessary, they neglect to address some very important areas. This article looks at the diagnosis, and

addresses both the structure and shortfalls of some of the proposed solutions as they relate to the mortgage and credit crisis.

DIAGNOSIS

A failure to properly diagnose a problem will result in ineffective remedies and not prevent the problems from recurring. Therefore, the initial step to solving the turmoil in the housing and financial markets is to fully understand the three root problems that caused the crisis in the first place.

Problem 1: Lack of Market Discipline and Reckless Decision-Making by U.S. Mortgage Loan Funders

In the United States, mortgage money comes from financial market investors who buy bonds on the bond market. The companies that issue and market these bonds to investors use mortgages as collateral to "secure" the bonds

(mortgage backed securities (MBS)) (see Exhibit 1).

The process involves four steps:

1. Consumers get loans from mortgage banks or brokers.
2. Mortgage banks or brokers sell these mortgages to secondary market investors like Fannie Mae, Freddie Mac, and other financial institutions.
3. Secondary market investors package these mortgages as securities or bonds; that is, they "securitize" the mortgages into a financial product to be sold to Wall Street investors such as mutual fund companies and individual investors.
4. Warehouse lenders provide the interim financing for the mortgage banks. In

other words, if a mortgage bank is not taking in deposits from banking customers, institutions known as “warehouse lenders” fill the gap and lend money to mortgage banks during the interim period. These short-term loans are “warehoused” for periods lasting from 1-90 days, while the mortgage banks arrange the sale of these loans to secondary market investors.

The deterioration in subprime underwriting guidelines and the subsequent boom in subprime originations began in late 2004 as Wall Street investors began looking for higher returns that were unavailable with more traditional MBS. Mortgage banks fed Wall Street’s appetite by relaxing their guidelines and issuing loans with higher interest rates to borrowers who otherwise may not have been able to afford a home purchase or mortgage refinancing outside of these much looser guidelines.² These higher rate loans were then packaged and sold to Wall Street investors in the form of higher-yielding residential mortgage backed securities (RMBS).

As long as property values continued to rise, homeowners had every incentive to continue making their payments, and they even began cashing out the newly minted home equity that was created from rising home values. However, real estate markets began slowing down in late 2006, causing homeowners to think twice about continuing to make mortgage payments that they could ill afford.

The subprime loans began souring in 2007,³ causing Wall Street investors to pull the plug and stop buying the risky mortgages from the mortgage banks. Wall Street in fact started requiring the mortgage banks to buy back all of the loans that they had sold in the first place due to the increasingly poor performance of the

overall portfolios of mortgages that had been sold. In other words, the system started working in reverse. Instead of providing new money to the mortgage banks, Wall Street started taking money back from the mortgage banks. To compound the problem, the warehouse lenders who were providing interim financing from the sidelines created a “run on the mortgage banks” by closing down their lines of credit and calling all their loans due. This vicious cycle began in earnest in the third quarter of 2007 and has continued ever since.

The first root cause of the problem, therefore, was the breakdown in underwriting standards for subprime mortgages, which was in turn caused by increased demand for higher yielding MBS on the part of Wall Street investors. In the heat of all the competition to sell more and more loans to Wall Street, mortgage banks stumbled over themselves and became more and more reckless in their underwriting guidelines.

The breakdown in market discipline did not necessarily start and stop with the mortgage banks. Even as mortgage banks were constantly innovating to create new types of subprime mortgages with ever deteriorating guidelines, Wall Street participants embarked on perhaps the biggest era of structured financial product innovation in history. Slicing, dicing, and layering of investment risk soared through the creation and expansion of collateralized debt obligations (CDOs),⁴ structured investment vehicles (SIVs),⁵ and credit default swaps (CDS).⁶ These innovations, coupled with the unprecedented leverage opportunities exaggerated both asset values and financial exposures to levels that were previously unimaginable.

The value of outstanding CDS has climbed to a staggering \$45 trillion according to the International Swaps and Derivatives Association. This is

EDITORIAL ADVISORY BOARD

EDITOR-IN-CHIEF

Mark H. Leeds
leedsm@GTLaw.com
GREENBERG TRAURIG LLP
NEW YORK CITY

MANAGING EDITOR

Barbara Campbell, J.D.
barbara.campbell@thomson.com

ASSOCIATE EDITOR

David Yanes, J.D.

SENIOR EDITOR

Robert Gallagher, J.D., CPA

ADVERTISING SALES

Terry Storholm, Manager
WG&L Journals Advertising
610 Opperman Drive
Eagan, MN 55123
Phone: 800-322-3192
Fax: 651-687-7374
terry.storholm@thomson.com

CONTRIBUTORS AND ADVISORS

Vincent Aquilino
UNGARETTI & HARRIS
CHICAGO

Micah Bloomfield
STROOCK & STROOCK & LAVAN
LLP
NEW YORK CITY

Jeffrey Bryant
SCHOOL OF ACCOUNTANCY,
WICHITA STATE UNIVERSITY
WICHITA, KANSAS

Stevie D. Conlon
ARLINGTON HEIGHTS, IL

Robert N. Gordon
TWENTY-FIRST SECURITIES
CORPORATION
NEW YORK CITY

Peter H. Huang
JAMES BEASLEY LAW SCHOOL
TEMPLE UNIVERSITY
PHILADELPHIA, PA

Thomas A. Humphreys
MORRISON & FOERSTER LLP
NEW YORK CITY

James A. Johnson
DELOITTE & TOUCHE LLP
NEW YORK CITY

Ira Kawaller
KAWALLER & CO.,
BROOKLYN

Kevin Keyes
FRIED, FRANK, HARRIS, SHRIVER &
JACOBSON
WASHINGTON, D.C.

Lawrence Lokken
U. OF FLORIDA COLLEGE OF LAW
GAINESVILLE

Roger D. Lorence
SADIS & GOLDBERG, LLP
NEW YORK CITY, NY

John F. Marshall, Ph.D.
MARSHALL, TUCKER & ASSOC.
PORT JEFFERSON

Gregory May
FRESHFIELDS BRUCKHAUS
DERINGER
NEW YORK CITY

Robert H. Scarborough
FRESHFIELDS BRUCKHAUS
DERINGER,
NEW YORK CITY

Perry J. Shwachman
SIDLEY AUSTIN LLP
CHICAGO

Lewis R. Steinberg
UBS SECURITIES LLC
NEW YORK CITY

COUNTRY CORRESPONDENTS

Argentina
Patricia Lopez Aufranc
MARVAL, O'FARRELL & MAIRAL,
BUENOS AIRES

Australia
Tony Rumble
SAVINGSFACTORY LTD,
SYDNEY

Germany
Dr. Stephan Eilers
Holger Häuselmann
FRESHFIELDS BRUCKHAUS
DERINGER
COLOGNE/FRANKFURT

India
J.D. Agarwal, Chairman
INDIAN INSTITUTE OF FINANCE
NEW DELHI

Italy
Lisa Curran, Esq.
UGHY & NUNZIATE
ROME

Japan
Kenju Watanabe
SKADDEN, ARPS, SLATE, MEAGHER
& FLOM, NEW YORK CITY

Takuhide Mitsui
MITSUI, YASUDA, WANI & MAEDA
TOKYO

Derivatives Financial Products Report (ISSN 1536-397X) (TDVN) is published monthly by Warren, Gorham & Lamont, division of Thomson/TTA, 395 Hudson Street, New York, NY 10014. Copyright © 2008 Thomson/TTA. All rights reserved. No part of this newsletter may be reproduced in any form or incorporated into any information retrieval system without the express written permission of the copyright owner. Requests to reproduce material should be addressed to Copyright Clearance Center, 222 Rosewood Drive, Danvers, MA 01923, (978) 750-8400, fax (978) 750-4470 or 4744. Requests to publish material or to incorporate material into computerized databases or any other electronic form, or for other than individual or internal distribution, should be addressed to Thomson/TTA, 117 East Stevens Avenue, Valhalla, NY 10595, (800) 323-8724. Annual subscription price: Print \$350; Checkpoint (electronic version, one user) \$475.

Subscriptions: 1-800-431-9025.

Editorial inquiries: Contact Barbara Campbell, 395 Hudson St., New York, NY 10014, (212) 807-2182; email: barbara.campbell@thomson.com.

This publication is sold with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional advice or services. If such advice or services are sought, the services of a lawyer, accountant or other professional should be obtained.

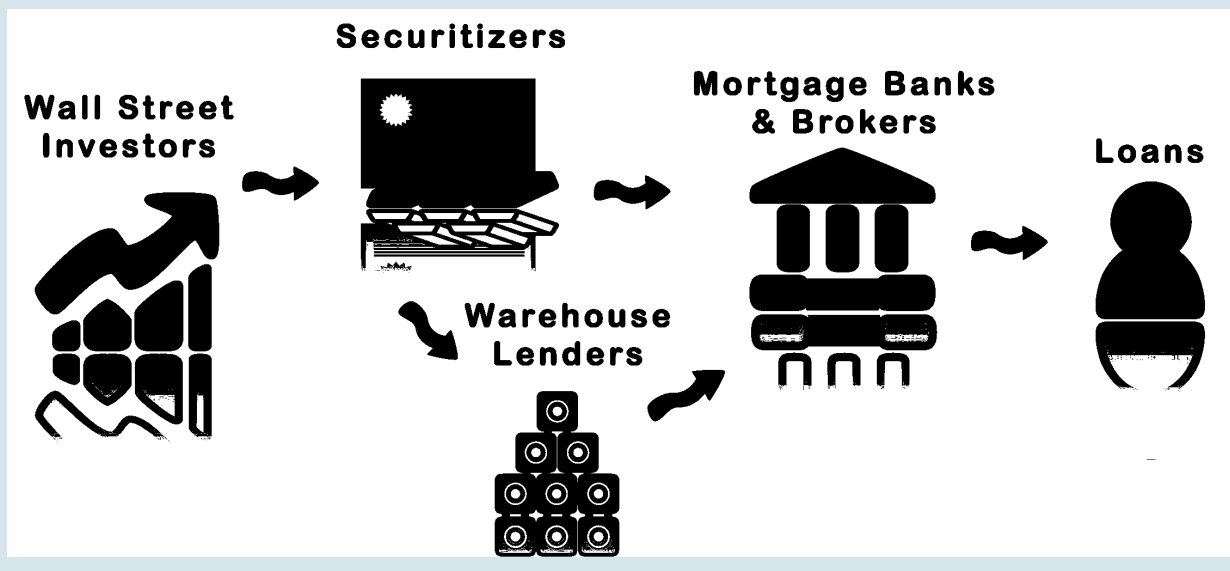
In response to IRS Circular 230 requirements, Thomson-TTA advises that any discussions of federal tax issues in its publications and products, or in third-party publications and products on its platforms, are not intended to be used and may not in fact be used to avoid any penalties under the Internal Revenue Code, or to promote, market, or recommend any transaction or subject addressed therein.

POSTMASTER: send address changes to Derivatives Report, 117 East Stevens Avenue, Valhalla, NY 10595.

THOMSON
TAX & ACCOUNTING

EXHIBIT 1

U.S. Mortgage Market Source Funds



roughly twice the size of the entire U.S. stock market, which is valued at about \$22 trillion. The *Economist* magazine recently characterized the situation by reporting that investment banks have been turned into “debt machines that trade heavily on their own accounts,” with Goldman Sachs using about \$40 billion of equity as the foundation for \$1.1 trillion of assets and Merrill Lynch using about \$30 billion of equity as the foundation for \$1 trillion of assets. The U.S. financial services sector share of total corporate profits mushroomed from 10% in the early 1980s to 40% at its peak in 2007. The sector’s share of stock market value grew from 6% to 19%, while the industry employed only 5% of private sector workers.⁷

The rapid innovation that occurred in the financial markets was not met with the proper discipline on the part of the institutions that created and traded in these structured financial products. When investors decide which bonds and securities to buy, they rely on information provided to them by credit rating agencies who issue report cards and grade the securities based on how much risk they

think is involved. Due to the inventiveness and complexity of the new structured products, and the lack of experience of rating agencies in dealing with such complex instruments, the AA and AAA ratings assigned to the securities were often over-rated and the risks were not properly accounted for. Conflicts of interest were also rife as the issuers of these complex securities would “shop” for rating agencies willing to give them the highest grade. Further, investor complacency caused an over-reliance on the ratings assigned by the rating agencies as investors failed to engage in an independent process of due diligence.

As the credit markets began to unravel in July and August 2007, liquidity evaporated and the complex investment structures became difficult if not impossible to value—what is something worth when there are no buyers? We are still feeling the effects of this scene well into 2008, as demonstrated by the recent run on the once venerable investment bank Bear Stearns.⁸

Problem 2: Chaotic Mortgage Origination Process Confusing Borrowers

Mortgage companies not affiliated with regulated depository institutions originated about half of all subprime mortgages in 2006. There is very weak government oversight of these entities, as most states do not have any licensing requirements for individual mortgage salespeople. Financial incentives are structured to pay mortgage originators higher commissions for originating mortgages with higher interest rates. Moreover, mortgage originators have little incentive to ensure that the loans they originate are affordable for borrowers. Secondary market investors bear all of the risk of borrower defaults, and originators can simply make their commissions and move on to the next deal. These factors have resulted in a loosely regulated and chaotic mortgage process that confuses borrowers.

Problem 3: Government Failure to Properly Regulate the Mortgage and Financial Industry

As illustrated above, the government failed to properly regulate the mort-

gage origination process as licensing requirements are scarce and there is no standardized method of preventing, catching and prosecuting fraudulent mortgage practices. Government also failed to properly regulate excessive risk-taking in the financial markets, and the regulation that did exist was inept and wrought with loopholes. Treasury's Blueprint points out that many developing nations have regulatory structures that are more modernized and competitive than the U.S. regulatory structure.⁹

Two major problems with the U.S. regulatory structure are as follows:

1. No single regulator has information and authority to monitor systematic risk or the potential that a malfunction in one area of the system could cause a domino effect that would ripple through the entire economy at large. Therefore systematic risks go undetected or are often ignored (or both) due to lack of jurisdiction and oversight. In other words, "[w]hat we have here is a failure to communicate."
2. Duplication of certain common activities among regulators increases bureaucracy and drives up compliance costs. Further, jurisdictions between regulators get blurred and disputed. This hampers innovation and drives financial service firms to do business in foreign markets outside of the U.S. that have a more streamlined and efficient regulatory structure.

PROPOSED SOLUTIONS

Both the PWG report and Treasury's Blueprint contain numerous recommendations for reforming the way that financial and mortgage markets operate, as well as a sweeping restructuring of the U.S. financial regulatory

structure. The proposed changes are not likely to be effective in the near term because of the 2008 election and because they will require much debate and negotiation on all ends of the political spectrum. Nevertheless, the proposals will likely form the basic framework around which reforms will be debated. Therefore, an understanding of both the structure and the short falls of the proposals is advisable. The Blueprint is over 200 pages, and an exhaustive review is not possible here. Rather, the next section of the article focuses on some of the proposals that have direct relevance to the mortgage and credit crisis.

Short-Term Proposals

Three proposals are key.

PWG expansion. One of the proposals is to expand the PWG to include the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS). It also calls for the PWG to be given the lead in the effort to reform regulatory structures throughout the entire financial services industry. The PWG is chaired by the Secretary of the Treasury, meaning that Treasury would have a large role in future policy-making and reform discussions.

Mortgage origination. The Blueprint calls for the Federal Reserve Board ("the Fed") to continue writing regulations to implement national mortgage lending laws.¹⁰ Perhaps more importantly, the Blueprint calls for a new federal mortgage origination commission (MOC) to be created to evaluate, rate, and report the adequacy of each state's licensing and regulation of the mortgage origination process. Many states do not have any mortgage licensing laws, and those that have licensing rules often have inadequate standards that fail to

protect consumers. The Blueprint calls for the MOC to ensure that each state:

1. Reports and grades the personal conduct and disciplinary history of each licensed mortgage salesperson.
2. Requires minimum educational requirements for mortgage salespeople.
3. Establishes testing criteria and procedures for mortgage salespeople.
4. Implements license revocation standards for mortgage salespeople who violate the rules.

The MOC would then grade the adequacy of each state's regulatory process, and these "grades" would be used by the credit rating agencies when evaluating the quality of MBS originating from that state's underlying pool of mortgages. The public nature of these evaluations "should provide strong incentives for states to address weaknesses and strengthen their own systems."

Treasury claims that one major benefit of this proposal is that it "builds on existing state regulatory and supervisory systems, rather than establishing a new federal entity preempting state law." Nevertheless, this approach seems to fly in the face of Treasury's stated goals of creating a regulatory system that is based on "objectives" rather than one that focuses on the "functions" of the institutions that it regulates. For example, one loophole created by the proposed MOC is that mortgage salespeople who work for federally chartered banks would not be subject to the same licensing rules as the rest of the mortgage industry. Federally chartered banks have their own guidelines that need to be followed because their institution is regulated at the federal level by agencies that regulate the "functions" of federally chartered

banks.

Practically though, all individuals who sell mortgages to consumers should be required to follow the same guidelines regardless of whether they work for institutions that are regulated at the state or federal level. This would prevent a mortgage originator from committing fraud while being employed under one mortgage company only to leave the original employer for another while avoiding detection and prosecution. A national database of all individuals who sell mortgages should be maintained and accessible at the federal level, while every state should be required to enforce licensing guidelines and minimum continuing education requirements. This would enable reporting, detection, and enforcement of standardized mortgage origination practices that protect consumers, while bringing much needed clarity to the mortgage refinancing and home-buying process.

Federal Reserve liquidity provisioning and oversight. The Federal Reserve should be given more oversight over nondepository institutions such as investment banks to empower it to address liquidity needs in the market. Liquidity needs of nondepository institutions caused the Fed to establish the Term Securities Lending Facility (TSLF). Through the TSLF, the Fed has used its authority for the first time since the 1930s to provide access to the discount window to nondepository institutions, such as brokerage firms and investment banks.¹⁴ For the Fed to continue to innovate and effectively address the liquidity needs in the market without taking excessive risk, it should be given greater oversight over nondepository institutions. This oversight could take place primarily through information sharing and collaboration between the Fed and the Commodity Futures Trading Commission

(CFTC) and Securities and Exchange Commission (SEC), which would allow the Fed to “access examination information and accompany the SEC and CFTC on financial examinations.”

Intermediate-Term Proposals

Treasury would create a national bank charter and streamline the regulation of the futures and securities markets.

National bank charter. The Blueprint recommends phasing out the federal thrift charter over a two-year period, merging the OTS and the OCC during this timeframe, and creating one entity to charter banks at the federal level. The OCC was created in 1863 to charter national banks, and the OTS was created in 1989 as a successor regulatory agency to the Federal Home Loan Bank Board (FHLBB), an agency that had regulated and chartered national thrifts up to that point.

Historically, thrifts were primarily depository institutions that lent money only to their depositors, primarily by way of home mortgages. On the other hand, banks were depository institutions that engaged in a much wider variety of commercial banking activities. However, the evolution of the financial services industry over time has greatly blurred the lines of distinction between thrifts and banks. One of the main reasons why thrifts were needed in the past was to ensure that consumers had sufficient access to mortgage funding. However, Treasury has concluded that a separate thrift charter is unnecessary for several reasons, including:

1. *Asset securitization.* Thrifts are less relevant in the home mortgage area because approximately 60%-65% of all outstanding mortgages in the U.S. are securitized.

2. *Declining thrift market-share compared with that of commercial banks.* Ten percent of outstanding mortgage debt was held by thrifts at the end of 2005 compared with 50% in 1980, with the commercial banks achieving a 20% market share by the end of 2005.

Streamlined regulation of futures and securities markets.

Among other changes, the Blueprint recommends a merger of the CFTC and the SEC. Distinctions between the trading of securities, commodities, and futures have been greatly blurred. Stock, options, and futures exchanges are merging. Financial products are becoming increasingly complex, with both securities and futures components. Notwithstanding the recent mutual cooperation agreement that the CFTC and SEC signed in March 2008, jurisdictional disputes have often gone unabated. This has hindered or prohibited the development of certain financial products while adding unnecessary burdens and compliance costs to the industry.

Moreover, according to the Blueprint, there is no general surveillance and enforcement of inter-market trading, which leads to “gaps in investor protection and unnecessary market volatility.” There is also a lack of unified knowledge in the regulatory sector over risk concentration in the markets. “The lack of coordination between the futures and securities markets over clearance and settlement of transactions may contribute to increased market volatility and may impair market participants’ ability to accurately estimate their risk exposure. Further, if unable to assess the total risk exposure of potential customers, institutions might unnecessarily constrain lending... [A] unified agency would have the ability to better monitor overall financial sys-

tem risk and police the inter-linked markets.”

The merger of the CFTC and SEC makes sense, along with the other streamlined regulatory processes and procedures proposed in the Blueprint. These changes will surely make U.S. markets more efficient and competitive with foreign markets. Nonetheless, a most glaring shortfall in Treasury’s Blueprint is its failure to propose a way to efficiently regulate the \$45 trillion CDS markets or the credit agencies that grade CDOs, SIVs, and other complex investment structures. As outlined in the diagnosis above, innovation in the CDO, SIV, and CDS markets has been unprecedented in recent years. Excessive risk-taking and government failure to regulate these markets were major contributing factors to the current state of the mortgage and credit markets.

What specifically will be done to mitigate counterparty and other risks that have proven likely to pose grave systemic danger to the markets and the economy at large? It is one thing to propose a new regulatory regime, but entirely another to demonstrate how that regulatory regime will prevent a credit crisis of the current magnitude from recurring. The main problem in today’s credit markets is that financial institutions do not know how to value their assets or quantify their risk exposure. This uncertainty leads to a lack of confidence among market participants, which in turn causes liquidity to dry up.

What exactly will be done to assure that market participants have adequate information to value their assets and quantify their risk exposure? Will the new regulatory agency prescribe specific levels of acceptable leverage or minimum capital requirements among CDS counterparties? If so, what levels of leverage are acceptable and what capital requirements are needed? Should CDS contracts be

considered a form of credit insurance subject to insurance guidelines? If not, what will be done to ensure that financial institutions do not over-extend themselves in the CDS markets in a way that jeopardizes their operational viability and the safety of other market participants?

Further, what of the credit ratings agencies that are historically under the SEC’s jurisdiction? A breakdown in the rating agency systems was a major contributing factor to the credit crisis. The PWG report calls for credit rating agencies to better disclose the methods used to grade various investments while avoiding conflicts of interest—especially when grading “structured investments” that tend to be complex in nature. The PWG report also calls for issuers of structured investments to better disclose the risks associated with the investments that they sell. While Treasury’s Blueprint gives the MOC some oversight in affecting the credit ratings of MBS, it makes absolutely no mention how the credit ratings agencies would be better regulated when grading structured investments such as CDOs and SIVs.

This is a major shortfall in the Blueprint. After all, the breakdown in the ratings system was most hazardous when it came to the ratings of CDOs and SIVs themselves, not necessarily in the ratings of the underlying MBS that were used to build and create these complex structures. The inadequacies inherent in the credit rating process coupled with the sheer magnitude of the unregulated CDS markets pose grave systemic danger. These and other issues will need to be more comprehensively addressed to prevent a credit crisis of the current scope and magnitude from recurring.

Long-Term Proposals

The Blueprint recommends that a totally new regulatory regime be cre-

ated to completely replace the current structure. The new regime would comprise three regulators, as outlined below.

Market stability regulator. This regulatory agency (Federal Reserve) would be responsible for “overall conditions of financial market stability that could [affect] the real economy.” The Federal Reserve should assume this role because it already has significant experience and history in promoting macroeconomic stability. In other words, the Fed’s traditional role of providing liquidity and stability to the financial system should not only continue but be expanded to include broad regulatory powers that include:

1. Collecting appropriate information from financial institutions.
2. Disclosing information.
3. Collaborating with other regulators on rulemaking.
4. Taking corrective actions when necessary in the interest of overall financial market stability.

Prudential financial regulator. This regulatory agency (Prudential Financial Regulatory Agency) would focus on financial institutions that have some type of explicit government guarantees associated with their business operations (such as depository insurance). In this regard, both depository and other financial institutions should operate with several limitations:

1. Capital adequacy requirements.
2. Investment limits.
3. Activity limits.
4. Direct on-site risk management supervision.

Business conduct regulator. This regulatory agency (Conduct of Business Regulatory Agency) would focus on the business conduct of institu-

tions that deal with consumers, including responsibility over:

1. Disclosures.
2. Business practices.
3. Chartering or licensing of certain types of financial firms.

In addition to the three regulatory agencies, a new Federal Insurance Guarantee Corporation (now FDIC) would function as an insurer for institutions that are regulated by the prudential financial regulator. Also, a new “corporate finance regulator” would be responsible for general issues related to corporate oversight in the public securities markets, including these and other corporate issues:

1. Corporate disclosures.
2. Corporate governance.
3. Accounting and auditing oversight.

The current form of financial regulation in the U.S. has been characterized as “functional” or as an “institutionally based functional system.” This means that separate regulatory agencies are responsible for regulating financial institutions based on their “functional” lines of doing business, such as banking, insurance, securities, and futures. This regulatory structure is effective only if the lines of business remain distinct and separate, where no one line of business has the power to pose systemic danger to the markets or economy at large. However, as demonstrated, business lines have blurred with the evolution of the financial markets and their role in the broader economy. Therefore, a new regulatory structure is needed to adequately address the needs of today’s market environment.

The proposed form of financial regulation is characterized as an “objectives-based” structure. This means that regulatory agencies are

created to handle certain objectives, such as market stability regulation, prudential financial regulation, and business conduct regulation. Each regulatory agency would have all power necessary to meet its mission and objectives, regardless of the financial institution with which is dealing. For example, the market stability regulator would be empowered to provide liquidity to a financial institution that is chartered by the prudential regulator and whose business practices by way of conduct and financial disclosures are policed by the business conduct regulator.

This optimum system of regulation seems to make sense in that it creates a streamlined rule-setting and compliance process based on the market activities in which a financial institution engages. Further, regulators operating under this structure would be equipped to recognize and adequately address systemic risks based on their specific objectives. The market stability regulator would have adequate oversight to mitigate liquidity risks. The prudential financial regulator would have adequate oversight to limit excessive risk-taking and lack of market discipline among financial institutions. The business conduct regulator would have adequate oversight over disclosures and business practices as they relate to consumers. In this sense, the proposed “objectives-based” structure will be empowered to succeed where the current “functional” structure was destined to fail.

CONCLUSION

The U.S. mortgage and credit markets are the most advanced in the history, and the democratization of credit is one of the most powerful forces in the U.S. economy. Over-regulation will stifle innovation, while under-regulation will promote irresponsibility and excess. Treasury’s Blueprint contains some very useful suggestions,

but also leaves some room for creativity and improvement, as outlined above. The current credit crisis provides a unique opportunity for regulators and market participants to work together in shaping the future of how the financial markets operate. This is an exciting time for those who can rise to the occasion and seize the unprecedented opportunities to build a more sustainable regulatory framework for the financial markets. ■

GIBRAN NICHOLAS is a professional speaker, writer, and entrepreneur, and the founder, Chairman, and CEO of the CMPS Institute, a national training and certifying organization created to empower key stakeholders in the mortgage and financial services industries. He can be reached at 888-608-9800 or Gibran@CMPSInstitute.org.

- 1 See www.ustreas.gov/press/releases/hp871.htm. The PWG was originally formed in March 1988 by President Reagan in response to the savings and loan crisis and the stock market crash of 1987. The group includes the Department of the Treasury, Board of Governors of the Federal Reserve System (“the Fed”), Commodity Futures Trading Commission, and Securities and Exchange Commission. In August 2007, the PWG was specifically tasked by President Bush to review and propose solutions to the underlying causes of financial market turmoil that began at that time.
- 2 Lending standards deteriorated to the point where 95%-100% financing became available to borrowers with very poor credit histories and little or no documented income. This era was captured with the “No Income, No Credit, No Problem!” mortgage advertisements that were common from 2004-2006.
- 3 According to the PWG report, the delinquency rate for the total stock of adjustable rate subprime mortgages reached 20% in late 2007, while the delinquency rate on the total stock of fixed-rate subprime loans reached 8%.
- 4 A CDO is a type of structured investment product that is constructed from a portfolio of fixed income assets such as bonds. The assets are divided into different “tranches” or layers of default risk, and these tranches are then sold to investors. The losses from defaults are applied in reverse order of seniority, so the junior tranches experience losses first and therefore carry higher yields to compensate for this risk.
- 5 A structured investment vehicle (SIV) is a type of structured investment fund that borrows money by issuing short-term securities to invest in longer-term securities with presumably higher yields.
- 6 A CDS is the most widely traded derivative contract under which two counterparties agree to isolate and separately trade the credit risk of at least one third party. A buyer of a CDS is purchasing insurance against the default of the third party, while a seller of a CDS is guaranteeing the credit-worthiness of the third party.
- 7 “What went wrong in the financial system—and the long, hard task of fixing it,” *The Economist*,

March 22, 2008, www.economist.com/opinion/displaystory.cfm?story_id=10880718.

- 8 Bear Stearns was one of the largest counterparties in the \$45 trillion dollar CDS market. In the wake of the credit crisis, traders and other financial institutions became wary of doing business with Bear, effectively shutting it out of a market in which it was the largest player. This "run" on Bear Stearns necessitated a joint rescue operation by the Federal Reserve Bank of New York and JPMorgan Chase in which JPMorgan is assuming Bear's counterparty positions in the CDS markets.
- 9 "Congress established the national bank charter in 1863 during the Civil War, the Federal Reserve System in 1913 in response to various episodes of financial instability, and the federal deposit insurance system and specialized insurance depository charters (e.g., thrifts and credit unions) during the Great Depression. Changes were made to the regulatory system...in response to other financial crisis...or as enhancements...; but for the most part the underlying structure resembles what existed in the 1930s."
- 10 For example, the Federal Reserve Board of Governors proposed sweeping reforms to the mortgage origination process, especially for subprime loans. These reforms were announced on December 18, 2007, and published in the Federal Register on January 9, 2008. Among other items, the Fed prohibited certain deceptive advertising practices and proposed that creditors be required to verify income and assets when underwriting subprime mortgages.
- 11 These nondepository institutions have even been allowed to use AA and AAA rated non-agency MBS as collateral for loans from the TSLF. This has further enhanced liquidity in the MBS markets by empowering the Fed to become a "market-maker" for these otherwise illiquid securities.

THE VALUE OF
OUTSTANDING CREDIT
DEFAULT SWAPS HAS
CLIMBED TO A STAGGERING
\$45 TRILLION, ROUGHLY
TWICE THE SIZE OF THE
ENTIRE U.S. STOCK MARKET.

AS TREASURY'S BLUEPRINT
POINTS OUT, MANY
DEVELOPING NATIONS HAVE
REGULATORY STRUCTURES
THAT ARE MORE
MODERNIZED AND
COMPETITIVE THAN THE U.S.
REGULATORY STRUCTURE.

A MOST GLARING
SHORT FALL IN THE
TREASURY'S BLUEPRINT IS ITS
FAILURE TO PROPOSE A WAY
TO EFFICIENTLY REGULATE
THE \$45 TRILLION CDS
MARKETS OR THE CREDIT
AGENCIES THAT GRADE
CDOS, SIVS, AND OTHER
COMPLEX INVESTMENT
STRUCTURES.

THE BLUEPRINT MAKES
ABSOLUTELY NO MENTION
HOW THE CREDIT RATINGS
AGENCIES WOULD BE
BETTER REGULATED WHEN
GRADING STRUCTURED
INVESTMENTS SUCH AS
CDOS AND SIVS.

THE PROPOSED
"OBJECTIVES-BASED"
STRUCTURE WILL BE
EMPOWERED TO SUCCEED
WHERE THE CURRENT
FUNCTIONAL" STRUCTURE
WAS DESTINED TO FAIL.