

**ANATOMY OF A MORTGAGE MELTDOWN:
THE STORY OF THE SUBPRIME CRISIS, THE
ROLE OF FRAUD, AND THE EFFICACY OF THE
IDAHO SAFE ACT**

COMMENT

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I. GREATER THAN THE SUM OF ITS PARTS

In the case of all things which have several parts and in which the whole is not, as it were, a mere heap, but the totality is something besides the parts, there is a cause

—Aristotle¹

It began as a bubble in the housing market, escalated into a full-blown banking crisis, and came dangerously close to turning into “the first U.S. depression since the Great Depression.”² Though abating, the Subprime Crisis³ rolls on, and its coda—a spate of responsive regulations—is beginning to take effect. One such regulation is the Secure and Fair Enforcement in Mortgage Licensing Act of 2008: the SAFE Act. Its goal is to prevent a recurrence of the rampant mortgage fraud that occurred during the crisis. This article will evaluate the SAFE Act, examine its focus on mortgage brokers (as opposed to loan officers), and compare the differing approaches of Washington and Idaho in implementing it.

It goes without saying that one cannot assess a regulation without understanding the problem it intends to fix; that is certainly the case here. But a reasonable evaluation of the SAFE Act depends on much more. The importance of preventing mortgage fraud only becomes clear when the fraud is seen as a small but integral piece of a larger puzzle. What made the Subprime Crisis so devastating was that it was the product of numerous factors that interacted in the worst possible ways. Risky loans, securitization, derivatives, activist monetary policy, and mortgage fraud are not so dangerous in isolation. But when these components combine, a perverse synergy occurs: risk is compounded and distributed in ways that the financial system cannot bear. Understanding each of these components and the result of their commingling is essential to assessing any post-crisis regulation.

To that end, this article begins with an explanation of the Subprime Crisis. The goal is not to present a hyper-technical financial treatise or exhaustive historical account. Rather, the author seeks to explain the complete crisis in a comprehensible way, and provide the history and context that is necessary for evaluating the SAFE Act. Mortgage fraud in particular is then examined—what it is, who commits it, and its extent during the crisis. This is done to address the controversy regarding the SAFE Act’s focus on independent mortgage brokers, as opposed to mortgage lending officers employed by banks. Taking a close look at which of these groups committed more fraud tests the wisdom of this

1. 2 ARISTOTLE, *Metaphysics Book VIII (H) Part 6*, in THE COMPLETE WORKS OF ARISTOTLE 1552, 1650 (Jonathan Barnes ed., W.D. Ross trans., 1984).

2. Richard A. Posner, *A Failure of Capitalism: The Crisis of ‘08 and the Descent Into Depression* vii (2009).

3. The global financial crisis that began in 2007 and persists in 2011 is a product of many factors, one of which is subprime lending. To keep things simple this article will refer to the crisis as a whole as the “Subprime Crisis,” or just “the crisis.”

focus. In fact, statistics show that mortgage brokers and borrowers—but not bank employees—committed virtually all the mortgage fraud that precipitated the crisis. A detailed look at the SAFE Act then follows. After discussing the Act itself, and its federal and state components, current bank regulations are examined through the prism of one banking regulator—the Office of the Comptroller of the Currency. Because the five agencies that regulate insured banks⁴ do so in a similar manner, a look at one is essentially a look at bank regulation as a whole. As mentioned, banking regulators declined to extend certain requirements of the SAFE Act to bank-employed brokers. Their reasoning was that those requirements would overlap with existing bank regulations, and an examination of OCC regulations shows this to be true. Finally, the Idaho and Washington state licensing systems made pursuant to the SAFE Act are contrasted. These states have taken divergent approaches to licensing, and recommendations are made based on which approach makes the most sense. Generally speaking, Idaho’s version of the SAFE Act could be improved with some minor revisions.

It is important to keep in mind that mortgage fraud was but one piece of a multi-piece catastrophe; the inherent dangers of fraud were amplified and reinforced by other pieces, and vice versa. By the same token, no single cause was responsible for the crisis—it was a whole greater than the sum of its parts. Because of this, the story of the entire crisis—of all its parts—is more than simple context or perfunctory background reading: it is indispensable for evaluating the SAFE Act and all other post-crisis regulation. Those who profited from the crisis did so in part by presenting what was happening as too complicated to fathom—not so. The entire story of the Subprime Crisis is wholly understandable, and a prerequisite for effective regulation moving forward.

4. Those agencies are the Office of the Comptroller of the Currency (OCC), The Federal Deposit Insurance Corporation (FDIC), The Federal Reserve, The Office of Thrift Supervision (OTS), and the National Credit Union Association (NCUA). *See also infra* text accompanying note 305.

II. THE STORY OF THE SUBPRIME CRISIS

Why are they lending money to people who can't afford to pay it back?

—Alex Blumberg⁵

A. Monetary Policy & Mortgage Backed Securities

A fair evaluation of the SAFE Act requires a clear understanding of the Subprime Crisis that preceded it. And in one sense, explaining the crisis is simple: Banks made an abundance of imprudent loans to risky borrowers. It should be no surprise that so many of those loans ended up in default, but making sense of this raises a deeper question: Exactly why did so many banks seem to abandon lending standards at the start of the twenty-first century? The answer can be found in the long and complex story of the Subprime Crisis. Like most stories, it is one best told from the beginning. Ironically, the subprime story is a sequel—it begins where a previous financial crisis left off.

When the dot-com stock bubble burst in March of 2000, the Federal Reserve began an aggressive policy of lowering interest rates in order to encourage lending and stimulate the economy.⁶ The 9/11 terrorist attacks and ensuing recession provided further incentive for monetary intervention, so the Federal Funds rate⁷ hovered at around 1% for nearly two years.⁸ One effect of this was that the average return on a U.S. Treasury Bond would be meager.⁹ At the same time, the United States had a significant trade deficit with China, India, and oil-exporting “petrodollar” nations in the Middle East.¹⁰ These once-poor countries were swiftly emerging as global economic powers. And as a result, the amount of global debt securities dramatically increased, from \$37 trillion in

5. David Carr, *Daring to Say Loans Made No Sense*, N.Y. TIMES, Sept. 28, 2008, at C1 (quoting Alex Blumberg).

6. POSNER, *supra* note 2, at 38.

7. Also known as the “discount rate,” this rate is the interest rate set by the Federal Reserve for the loans it makes to other lending institutions. *The Discount Rate*, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, <http://www.federalreserve.gov/monetarypolicy/discountrate.htm> (last updated July 19, 2011). The Federal Funds rate has a close correlative effect on the Prime rate, which itself is a benchmark used by banks to determine the interest rate of various commercial and consumer loans. *What Is the Prime Rate, and Who Borrows at That Rate?*, FEDERAL RESERVE BANK OF SAN FRANCISCO (June 2005), <http://www.frbsf.org/education/activities/drecon/2005/0506.html>.

8. *Open Market Operations*, BOARD OF GOVERNORS OF THE FEDERAL RESERVE, <http://www.federalreserve.gov/monetarypolicy/openmarket.htm> (last updated Jan. 26, 2010); see also Randolph C. Thompson, *Mortgage Backed Securities, Wall Street, and the Making of a Global Financial Crisis*, 5 BUS. L. BRIEF OF AM. U. 51, 53 (2008).

9. See, e.g., *Selected Interest Rates (Daily) - H15*, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, available at <http://www.federalreserve.gov/releases/h15/data.htm> (use link for treasury constant maturities, 10 year annual) (last visited Oct. 31, 2011).

10. POSNER, *supra* note 2, at 38–39. See also Matthew Higgins et al., *Recycling Petrodollars*, CURRENT ISSUES IN ECON. & FIN., Dec. 2006, at 1.

Home Loan Mortgage Corporation (Freddie Mac) soon took up securitization thereafter.²³ The process, explained by Fannie Mae, works as follows:

[L]enders sell groups of mortgages with similar characteristics into the secondary mortgage market to issuers or guarantors of mortgage-backed securities, including Fannie Mae. We pool loans that generally conform to our standards and convert them into single-class mortgage-backed securities known as Fannie Mae MBS, which we then guarantee as to timely payment of principal and interest.²⁴

In other words, a lender could convert the home loans on its books into cash by selling them to Fannie Mae, which would pool thousands of individual mortgages into mortgage-backed securities (MBS). If you purchased an MBS bond, your investment's revenue stream came from homeowners making their house payment.²⁵ The situation was win-win: Lenders traded their illiquid loans for cash, and institutions that wanted the dependable returns of the United States housing market, but had no interest in dealing with the complexities of home financing, could have them.²⁶

In the early days of mortgage securitization, the biggest risk to investors was not that homeowners would default on their loans. For one thing, Fannie Mae and Freddie Mac would only pool "prime" loans, or those made to borrowers who were very likely to make their payments.²⁷ Furthermore, Fannie and Freddie guaranteed MBSs in case of homeowner default.²⁸ The real risk to investors was being paid too soon: if a homeowner refinanced his mortgage and paid off the original loan, a fraction of the MBS revenue stream vanished.²⁹ And homeowners typically refinance when interest rates go down. This meant that an investor "didn't know how long his investment would last, only that he would get his money back when he least wanted it"—when interest payments were lower.³⁰

23. Alan Kronovet, *An Overview of Commercial Mortgage Backed Securitization: The Devil Is in the Details*, 1 N.C. BANKING INST. 288, 291–92 (1997).

24. *Basics of Fannie Mae MBS*, FANNIEMAE, <http://www.fanniemae.com/mbs/mbsbasics/index.jhtml?p=Mortgage-Backed+Securities&s=Basics+of+Fannie+Mae+MBS> (last visited Oct. 9, 2011).

25. It probably goes without saying that the mechanics and legal issues involved here are complex. For an excellent in-depth discussion of structured finance, its history, ideal "securitizable" assets, achieving legal separation of lenders selling assets and the special purpose vehicles that issue the bonds, and the regulatory framework that these deals must operate under, see Schwarcz, *supra* note 22.

26. *See id.*; POSNER, *supra* note 2, at 55.

27. POSNER, *supra* note 2, at 49; MICHAEL LEWIS, *THE BIG SHORT* 7 (2010).

28. *See* FANNIE MAE, *MULTIFAMILY DMBS PROSPECTUS 1* (2005), *available at* http://www.efanniemae.com/syndicated/documents/mbs/mbspros/MF_DMBS_January_1_2005.pdf; *see* FREDDIE MAC, *MORTGAGE PARTICIPATION CERTIFICATES OFFERING CIRCULAR 1* (2011), *available at* http://www.freddiemac.com/mbs/docs/pcoc_062011.pdf.

29. LEWIS, *supra* note 27, at 7.

30. *Id.*

But the bonds were ingeniously structured to address prepayment risk.³¹ First, the pool of mortgages would be sliced into pieces known as tranches.³² An investor's risk and return would depend on the tranche he invested in.³³ Much like "a ground floor in a flood," the lowest tranche would be hit by the first prepayments, though it would carry a higher interest rate to compensate for the risk.³⁴ An investor in the next tranche would be hit by the next "wave" of prepayments.³⁵ This continued until the highest tranche, which paid the lowest interest rates "but had the greatest assurance that [an investor's] investment wouldn't end before he wanted it to."³⁶ Another way to think of this system was as a waterfall: the income stream would flow down, from the safest tranches at the top, to the riskiest at the bottom.³⁷ If the cash flow was disrupted, less would flow down, and the tranches at the bottom would be the first to lose out. The tranche system fractionalized the biggest risk of prime lending, and attracted institutional investors looking for safe yet profitable investments. And so it was that those who managed the global capital surplus found a way to tap into the debt of American homeowners.

B. The Housing Bubble & Subprime Lending

The influx of capital in the secondary mortgage market, coupled with sustained low interest rates, started the bubble in the housing market in the late 1990s.³⁸ The government helped it grow by encouraging homeownership not only expressly,³⁹ but also through its sponsorship of Fannie Mae and Freddie Mac, and the home loan interest deduction.⁴⁰ From 1997–2005, U.S. home prices swelled by 73%—the largest asset bubble in American history.⁴¹ As home prices shot up, first-time

31. *Id.*

32. Thompson, *supra* note 8, at 52.

33. *Id.*

34. LEWIS, *supra* note 27, at 7.

35. *Id.*

36. *Id.*

37. *See, e.g.*, FIN. CRISIS INQUIRY COMM'N, THE THEORY OF HOW THE FINANCIAL SYSTEM CREATED AAA-RATED ASSETS OUT OF SUBPRIME MORTGAGES, <http://fcic.law.stanford.edu/img/2010-0602-aaa-assets-chart.pdf> (last visited Oct. 9, 2011).

38. *See In Come the Waves*, THE ECONOMIST, June 16, 2005, http://www.economist.com/node/4079027?story_id=4079027 (correctly predicting that the housing bubble "looks like the biggest bubble in history"); *see also* Robert T. Miller, *Morals in a Market Bubble*, 35 U. DAYTON L. REV. 113, 132 (2009).

39. Sue Kirchoff & Barbara Hagenbaugh, *Greenspan Says ARMs Might Be Better Deal*, USA TODAY, Feb. 23, 2004, http://www.usatoday.com/money/economy/fed/2004-02-23-greenspan-debt_x.htm ("American consumers might benefit if lenders provided greater mortgage product alternatives to the traditional fixed-rate mortgage.") (quoting Alan Greenspan).

40. I.R.C. § 163(h)(2)(D) (2006).

41. *In Come the Waves*, *supra* note 38; Miller, *supra* note 38, at 132.

homebuyers were not the only ones getting in on the action; those who already had homes took out loans, too—“flipping” properties as a quick investment, refinancing current home loans to take advantage of the low interest rates, and taking out home equity loans for easy access to cash.⁴² Exemplifying the speculative nature of “bubble thinking,” twenty-first century houses were being seen less as homes, and more as investments.⁴³

Surging home prices led to increased securitization, as investors sought to tap into a booming market. And Wall Street’s increased demand for home loans to securitize necessitated riskier lending; after all, there is a finite supply of prime borrowers. To meet demand, lenders were incentivized to securitize subprime loans—loans made to borrowers with a high risk of defaulting.⁴⁴ Not surprisingly, lending money to those who might not be able to repay posed a much bigger problem than prepayment. Fractionalizing this risk required the use of “non-agency” securitization, and an adjustment to the tranche system.

Non-agency securitization meant the pooling of the riskier loans that did not conform to Fannie Mae and Freddie Mac credit standards. It was first used in the 1980s, but proliferated as the subprime market grew.⁴⁵ With this type of MBS, a pool of loans was sliced not by risk of borrower prepayment, but of nonpayment.⁴⁶ Homeowner defaults would first hit the lowest tranche, which was rated triple-B or lower.⁴⁷ Subsequent defaults would hit the higher tranches, which culminated in triple-A, “riskless” prime bonds at the top.⁴⁸ It is crucial to note that investors in non-agency MBSs had no agency guarantees to protect them; their risk was not prepayment, but actual loss.⁴⁹ If “defaults on the underlying pools of loans reached about 10%,” investors in the triple-B tranche would suffer significant losses.⁵⁰ Despite the increased risk, investors flocked to the now wide-open MBS market, and the amount of securitized non-agency loans jumped from almost \$670 billion in 2004 to over \$2 trillion in 2006.⁵¹ Fannie Mae and Freddie Mac soon followed

42. FCIR, *supra* note 13, at 5–6.

43. *See id.*

44. Sabry & Schopflocher, *supra* note 21, at 91; POSNER, *supra* note 2, at 23.

45. JOHN AUTHERS, THE FEARFUL RISE OF MARKETS: GLOBAL BUBBLES, SYNCHRONIZED MELTDOWNS, AND HOW TO PREVENT THEM IN THE FUTURE 49 (Jim Boyd et al. eds., 2010).

46. LEWIS, *supra* note 27, at 8.

47. *Id.* at 8, 73.

48. *See The Making of a Mortgage CDO*, WALL ST. J., Dec. 27, 2007, <http://online.wsj.com/public/resources/documents/info-normaSubprime0712.html>.

49. LEWIS, *supra* note 27, at 8.

50. Carrick Mollenkamp & Serena Ng, *Wall Street Wizardry Amplified Credit Crisis*, WALL ST. J., Dec. 27, 2007, at A1.

51. FIN. CRISIS INQUIRY COMM’N, PRELIMINARY STAFF REPORT: SECURITIZATION AND THE MORTGAGE CRISIS 12 (2010), available at http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/2010-0407-Preliminary_Staff_Report_-_Securitization_and_the_Mortgage_Crisis.pdf.

the lead of the private market, and began securitizing non-prime loans in 2005.⁵²

Before the housing bubble, subprime lending was a niche market—in 1996, only 9.5% of home loans were subprime, and less than half of these loans were securitized.⁵³ But by 2006, 23.5% of all new mortgages were subprime, and more than 60% of these loans were securitized.⁵⁴ To keep up with increased demand, lenders offered ever more creative loan products. For example, many subprime loans were Adjustable Rate (ARMs)—after a two-year, low interest rate “teaser” period, interest rates would increase significantly. Monthly payments would then balloon, becoming unaffordable.⁵⁵ Borrowers were either ignorant of this prospect, or were undeterred, as some took a calculated, speculative risk: “[t]hey expected to be compensated by rapidly increasing home prices, and they believed that those higher prices would permit them to refinance at a lower rate.”⁵⁶

As lending standards continued to deteriorate, banks expanded their use of negative amortization loans and the infamous “no-documentation” loan—sometimes known as a NINJA loan.⁵⁷ NINJA stood for “No income, no job, no assets,” which meant that a potential borrower did not need to show any proof of income or assets in order to qualify for a loan—she merely needed to *state* her income and assets.⁵⁸ The original purpose of these products was sensible: to facilitate lending to those whose incomes were difficult to verify (such as the self-employed), but who were otherwise reliable borrowers.⁵⁹ But during the boom, to many borrowers and brokers, little or no required documentation became “an open ‘invitation to fraud’ that justified the industry term” these loans were known by: ‘liar’s loans.’⁶⁰ With no one bothering to verify their claims, borrowers would frequently lie about their finances in order to obtain homes they could not afford.⁶¹ Mortgage brokers often collaborated in the fraud, or deceived ignorant borrowers as to the nature of the loan, in order to expedite the deal (and collect a commis-

52. Charles Duhigg, *Pressured to Take More Risk, Fannie Reached Tipping Point*, N.Y. TIMES, Oct. 4, 2008, <http://www.nytimes.com/2008/10/05/business/05fannie.html>.

53. FCIR, *supra* note 13, at 70.

54. *Id.*; Sabry & Schopflocher, *supra* note 21, at 91–92.

55. *See* Sabry & Schopflocher, *supra* note 21, at 93.

56. ROBERT J. SHILLER, *THE SUBPRIME SOLUTION: HOW TODAY’S GLOBAL FINANCIAL CRISIS HAPPENED, AND WHAT TO DO ABOUT IT* 50 (2008).

57. *See* POSNER, *supra* note 2, at 23.

58. *Id.*; *see* FCIR, *supra* note 13, at 9.

59. POSNER, *supra* note 2, at 110.

60. *Id.* at 110–11.

61. *Id.* at 160–65.

sion).⁶² Low- or no-documentation loans were a niche product no longer: they went from 2% of home loans in 2000 to approximately 9% in 2007.⁶³

The demand for home loans by both Wall Street and borrowers fueled the decrease in lending standards, and vice versa. Irresponsible borrowers “wanted to live beyond their means,”⁶⁴ and investment banks wanted more loans to securitize—lenders accommodated both by making increasingly risky loans. In a way, the first “victim” of this arrangement was an all-important question of lending: Will the loan be repaid? The notion of repayment quickly became an afterthought to borrowers, lenders, and Wall Street during the crisis, because “[t]he housing bubble, combined with the incentive system implicit in the securitization process, amplified moral hazard.”⁶⁵ In other words, because lenders were securitizing mortgages and selling them off to institutional investors, they no longer cared about the quality of the loan, or if borrowers even made their monthly payments.⁶⁶ Homeowner default was now someone else’s problem: some investor who had purchased the loan, and thereby purchased the risk.⁶⁷ This is why banks abandoned lending standards.

C. Inventing Demand & Obscuring Risk: The Magic of CDOs

The risks brewing in the housing bubble and subprime securitization would be drastically magnified by another exotic security: the collateralized debt obligation, or CDO. A CDO worked just like an MBS—for exorbitant fees,⁶⁸ an investment bank would purchase underlying assets, pool them together, and “issue[] securities in tranches that vary based on their place in the cash flow waterfall.”⁶⁹ Although CDOs had existed since the 1980s,⁷⁰ their use in the subprime market in the 2000s created a “security so opaque and complex that it would remain forever misunderstood by investors and rating agencies.”⁷¹

The reason for the proliferation of CDOs during the bubble was one of economics: Investment banks had difficulty selling the lowest-level

62. *Id.*

63. *Id.* at 110.

64. *Id.* at 7.

65. SHILLER, *supra* note 56, at 6–7.

66. See, e.g., Peter S. Goodman & Gretchen Morgenson, *The Reckoning: Saying Yes, WaMu Built Empire on Shaky Loans*, N.Y. TIMES, Dec. 27, 2008, at A1 (“If [former Washington Mutual financial representative Dana Zweibel] doubted whether customers could pay, supervisors directed her to keep selling, she said. ‘We were told from up above that that’s not our concern,’ she said. ‘Our concern is just to write the loan.’”).

67. AUTHERS, *supra* note 45, at 50; see also Roger Lowenstein, *Triple-A Failure*, N.Y. TIMES MAGAZINE, Apr. 27, 2008, <http://www.nytimes.com/2008/04/27/magazine/27Credit-t.html>.

68. FCIR, *supra* note 13, at 131 (“You’d hear statements like ‘Everybody and his uncle now wants to be a CDO manager’ . . . because it was very lucrative.”) (quoting Mark Adelson, Structured Finance Analyst at Nomura Securities).

69. *Id.* at 128 fig. 8.1.

70. One irony of CDOs is that they were invented by Drexel Burnham Lambert—financial firm of the S&L Scandal’s chief antagonist, Michael Milken. *Id.* at 129.

71. LEWIS, *supra* note 27, at 72.

MBS tranches (i.e., the first in line to take losses).⁷² This is not surprising, considering bankers themselves referred to these risky tranches as “toxic waste.”⁷³ Wall Street’s solution was to “create the investor”—or in other words, simply invent demand for the toxic tranches.⁷⁴ Investment banks did so in the following way: First, they would buy the lowest tranches of various mortgage-backed securities and pool them.⁷⁵ Once purchased and pooled together, the lower-rated tranches could then be “repackaged” into a brand new security with its own tranches—a CDO.⁷⁶ In other words, firms designed a new “tower” of debt, whose floors—from top to bottom—were simply the most toxic bottom floors from other securities.⁷⁷ Firms eventually purchased and re-tranched not just subprime MBS tranches, but also credit default swaps,⁷⁸ and even pieces of other CDOs.⁷⁹

After pooling together the riskiest tranches from other securities, how did Wall Street then manage to sell them? An ill-fated CDO known as “Norma CDO I” typified how it happened. In late February 2007,⁸⁰ Merrill Lynch selected the assets that would comprise Norma: \$1.5 billion of triple-B subprime bonds, derivatives, and other CDOs.⁸¹ After purchasing and pooling these assets together, they were duly sliced into tranches. Then, inexplicably, “all three [credit] rating companies gave slices comprising 75% of the CDO’s total value their highest, triple-A rating—implying [the tranches] had as little risk as Treasury bonds of the U.S. government.”⁸² Put another way, the credit rating agencies had deemed a security almost entirely made of triple-B assets as somehow no longer triple-B. The given justification was that the tranche system was once again fractionalizing risk, and that the CDO’s mixture of as-

72. FCIR, *supra* note 13, at 127.

73. See David Evans, *Banks Sell ‘Toxic Waste’ CDOs to Calpers, Texas Teachers Fund*, BLOOMBERG, June 1, 2007, <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aW5vEJn3LpVw> (“[Banks] also refer to [bottom tranches] as toxic waste because as more borrowers default on loans, these investments would be the first to take losses. The investments could be wiped out.”).

74. FCIR, *supra* note 13, at 127, 129–32 (“We told you these [triple-B-rated securities] were a great deal, and priced at great spreads, but nobody stepped up . . . [s]o we created the investor.”) (quoting a Credit Suisse banker at a securitization conference in 2002).

75. *Id.*

76. *Id.*

77. *Id.*

78. A credit default swap was a derivative that essentially functioned as insurance for (or a bet on) some other bond. See *infra* Part II.D. CDOs containing only swaps were known as “Synthetic CDOs.” See *infra* Part II.E.

79. If a CDO was made entirely of other CDO tranches it was known as a “CDO Squared.” FCIR, *supra* note 13, at 132.

80. MERRILL LYNCH & CO., NORMA CDO I LTD. PROSPECTUS i (2007), available at <http://www.propublica.org/documents/item/norma-cdo-i-ltd.-prospectus>.

81. Mollenkamp & Ng, *supra* note 50.

82. *Id.*

sets meant that it was diversified.⁸³ This justification has been described with no shortage of supernatural metaphors,⁸⁴ because in hindsight, it was a fiction. No amount of pooling, slicing, or rearranging could transmute triple-B assets into 75% triple-A, because the assets were all based on the same thing: the subprime market.⁸⁵ The assets were not diversified, but rather were “highly correlated”; the entire CDO was “toxic waste.”⁸⁶ This meant that if there were significant losses in subprime housing, *all* the CDO investors would be wiped out, even if they invested in the highest, ostensibly riskless upper tranche.⁸⁷

This created huge, unseen risks for safety-seeking investors, but from Wall Street’s perspective, “Creating the Investor” was a hit: sales of CDOs “more than doubled every year, jumping from \$30 billion in 2003 to \$225 billion in 2006.”⁸⁸ And the corresponding effect on subprime demand was as intended:

By 2004 creators of CDOs were the dominant buyers of the BBB-rated tranches of mortgage-backed securities, and their bids significantly influenced prices in the market for these securities. By 2005, they were buying “virtually all” of the BBB tranches. Just as mortgage-backed securities provided the cash to originate mortgages, now CDOs would provide the cash to fund mortgage-backed securities.⁸⁹

As for the fate of Norma CDO I, in November of 2007, seven months after Norma’s triple-B assets were blessed as triple-A, CDOs across the board began to feel the effects of the plummeting housing market.⁹⁰ With rapid housing market declines, analysts expected at least 20% of subprime securities to default, “a level that would wipe out most triple-B-rated securities.”⁹¹ Every tranche of Norma was downgraded to junk.⁹²

83. LEWIS, *supra* note 27, at 73.

84. THIS AMERICAN LIFE, PROGRAM #355: THE GIANT POOL OF MONEY (2008), *transcript available at* http://www.thisamericanlife.org/sites/default/files/355_transcript.pdf (“[A] CDO is sort of a financial alchemy. Jim takes that toxic stuff . . . [r]e-tranches [it], and presto”); LEWIS, *supra* note 27, at 73 (“[Goldman Sachs] . . . nifty solution to the problem of selling the lower [tranches] appears, in retrospect, almost magical . . . a credit laundering service”); AUTHERS, *supra* note 45, at 116 (“Then came another layer of alchemy: bundling [CDOs]”); Lowenstein, *supra* note 67 (“Obscure and dry-seeming as it was, this business offered a certain magic. The magic consisted of turning risky mortgages into investments that would be suitable for investors who would know nothing about the underlying loans.”). *See also* Mollenkamp & Ng, *supra* note 50.

85. LEWIS, *supra* note 27, at 73.

86. FCIR, *supra* note 13, at 146.

87. Mollenkamp & Ng, *supra* note 50.

88. FCIR, *supra* note 13, at 130.

89. *Id.*

90. Mollenkamp & Ng, *supra* note 50.

91. *Id.*

92. *Id.*

D. Credit Default Swaps

A derivative⁹³ known as the credit default swap (CDS) was yet another financial instrument that precipitated the crisis. Created by Wall Street in the late 1990s, a CDS is a hedge⁹⁴ that protects against the risk of bond default, and it operates in a simple way: the owner of a bond can enter into a contract with someone selling swaps.⁹⁵ The bond owner pays a monthly premium to the swap seller.⁹⁶ If the bond ever defaults, then there is an exchange: the swap seller receives the worthless bond, and the bond owner is paid for the former value of the bond.⁹⁷ The simplest way to view this is that the purchaser of a swap has purchased insurance for his bond—which explains why insurance companies such as AIG sold them.⁹⁸ Insurance and swaps are not identical though, as swaps are largely unregulated.⁹⁹ Two of these regulatory differences in particular led to an exponential increase of the already huge risks in the subprime market: lack of reserve requirements and the ability of third-parties to purchase swaps.¹⁰⁰

The first crucial difference between CDS protection and conventional insurance is that a party selling swaps did not need to maintain a specified amount of reserves.¹⁰¹ State regulations require that insurance companies maintain reserves, and for good reason: If disaster strikes, we want to be sure our insurers can cover the bill.¹⁰² For CDS protection, this was not the case. Companies such as AIG could—and did—sell billions of dollars' worth of CDS protection, without having billions of dollars on hand to pay the swap holders if the bonds defaulted.¹⁰³

A second peculiarity of CDS protection goes against another fundamental principle of insurance: The buyer of CDS protection did not have to actually own the bond being insured.¹⁰⁴ This is less insurance, and more gambling; instead of protecting your own investment in case of

93. A derivative is a “[f]inancial contract whose price is determined (derived) from the value of an underlying asset, rate, index, or event.” FCIR, *supra* note 13, at 540.

94. As in “hedging one’s bets” or risk exposure.

95. *Times Topics: Credit Default Swaps*, N.Y. TIMES (April 29, 2011), http://topics.nytimes.com/top/reference/timestopics/subjects/c/credit_default_swaps/index.html [hereinafter *Credit Default Swaps*].

96. *Id.*

97. *See id.*

98. AIG sold CDS protection through its now-defunct AIG Financial Products subsidiary. LEWIS, *supra* note 27, at 68–72.

99. POSNER, *supra* note 2, at 58; see Ari J. Brandes, *A Better Way to Understand the Speculative Use of Credit Default Swaps*, 14 STAN. J.L. BUS. & FIN. 263, 271 (2009).

100. FCIR, *supra* note 13, at 50.

101. POSNER, *supra* note 2, at 58.

102. *See, e.g.*, IDAHO CODE ANN. § 41-308(1) (2010) (“No insurer shall be authorized to transact insurance in this state which does not maintain reserves . . .”).

103. *See* FCIR, *supra* note 13, at 352.

104. *Id.* at 50–51.

an emergency, you are merely betting an emergency will befall someone else.

The reason that this is generally disallowed¹⁰⁵ in conventional insurance is simple: It shifts unbearable amounts of risk to the insurer. For example, imagine if fire insurance on your house could be purchased by anyone. The entire neighborhood might then purchase policies; i.e., place bets that your house would burn down. If your house did burn down, hundreds of people would have to be paid. Your neighbors would “win” the value of a house, but would never have to risk a house; they just had to pay a monthly premium.¹⁰⁶ And the insurance company would probably be bankrupt, as a fairly common event—a single house fire—would put it on the hook for a catastrophic number of payouts. The insurer would effectively be the owner of your charred, worthless house, for the price of hundreds and hundreds of houses.

This was exactly what was happening with credit default swaps. Because the buyers of the swaps did not own the underlying bond, “the credit risk . . . was now transferred to the seller of the swap”—the insurer.¹⁰⁷ Risks of bond default that were once borne solely by bondholders were spreading through the system and latching on to any bank or insurance company that agreed to become a “swallower of those risks.”¹⁰⁸ The shifting of risk not only encouraged investment in the most toxic securities,¹⁰⁹ but created a fatal side effect for AIG: When it agreed to sell nearly \$60 billion of swaps on subprime bonds, it became “in effect, the world’s biggest [owner]” of those bonds.¹¹⁰

E. Inventing Supply with Synthetic CDOs, and “The Big Short”

Credit default swaps encouraged investment in subprime securities and shifted huge risks of default from bondholders to insurers. But the role of CDS protection in the crisis was not over. By merging the credit default swap and the CDO, Wall Street created the final esoteric security that led to the crisis: the Synthetic CDO.

Recall that CDOs (the “towers” of toxic debt) were essentially a “credit laundering service”¹¹¹ that solved demand problems by repurchasing subprime tranches, pooling them, and bestowing triple-A ratings on the final product. With seemingly safe new credit ratings,

105. See Brandes, *supra* note 99, at 271.

106. Credit default swaps work the same way. See LEWIS, *supra* note 27, at 29. (“If I bought a credit default swap, my downside was defined and certain, and the upside was many multiples of it.”) (quoting Michael Burry).

107. P.M. Vasudev, *Default Swaps and Director Oversight: Lessons from AIG*, 35 J. OF CORP. L. 757, 763 (2010).

108. LEWIS, *supra* note 27, at 70.

109. See FCIR, *supra* note 13, at 141.

110. LEWIS, *supra* note 27, at 72; accord Mark Pittman, *Goldman, Merrill Collect Billions After Fed’s AIG Bailout Loans*, BLOOMBERG, Sept. 29, 2008, <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aTzTYtLNHSG8>.

111. LEWIS, *supra* note 27, at 73.

prime bond *was* that bond, with all its toxicity and risk, and a firm could create one without having to originate new mortgages.

This removed a crucial brake on subprime risk accumulation.¹²² Putting together an actual subprime bond takes actual home loans and homebuyers, which requires real time and money. But concocting a synthetic CDO that replicated that bond required no mortgage origination and no homebuyers, and could be “created out of thin air”¹²³ within weeks. For hefty fees, banks and insurance companies could easily “copy and paste” the riskiest mortgage bonds, over and over again. For example, Goldman Sachs’ Synthetic CDOs referenced 3,408 underlying mortgage bonds—610 of them twice.¹²⁴ In fact, “one single [MBS] was referenced in nine different synthetic CDOs.”¹²⁵ In that case, a foreclosure’s economic damage was magnified tenfold: It harmed not only the original bondholder, but the nine Synthetic CDO insurers betting on the bond (to say nothing of the homeowner).¹²⁶ The only winner would be the person who bet that the mortgage bond would fail.¹²⁷ And with Synthetic CDOs and swaps, making such a wager was easy: institutions selling them “no longer needed to accumulate a billion dollars’ worth of actual mortgage loans [to make a billion dollar bet]. All [they] had to do was find someone else in the market willing to take the other side of the bet.”¹²⁸

The “other side of the bet” on the subprime market was the individuals and firms that foresaw the end of the housing bubble.¹²⁹ Armed with the ability to bet on securities they did not own, savvy investors bought swaps on the riskiest bonds: those backed by subprime loans, and those issued by the investment banks and insurance companies themselves, credit rating agencies, even construction companies—anything that might go under if the housing market started to fail.¹³⁰ Incredibly, the other side of the bet could even include the investment bank that created the Synthetic CDO in the first place.¹³¹ Firms placed

122. *Id.* at 191.

123. *The Credit Markets: In the Shadows of Debt*, THE ECONOMIST, Sept. 21, 2006, <http://www.economist.com/node/7941780> (“The problem, broadly identified by many regulators, is that not a lot is known about how [CDOs and swaps] behave in unusual conditions. Even if they normally mitigate risks, they might suddenly magnify them when financial conditions seriously deteriorate. The products have been developed in a decade when interest rates have been low, the appetite for risk high and liquidity ample. It is easy to assume they are always a benign influence. But it is hard to know how they will react when hard times return.”).

124. FCIR, *supra* note 13, at 145–46.

125. *Id.*

126. *Id.* at 145. (“When borrowers defaulted on their mortgages, the investors expecting cash from the mortgage payments lost. And investors betting on these mortgage-backed securities via synthetic CDOs also lost (while those betting against the mortgages would gain). As a result, the losses from the housing collapse were multiplied exponentially.”).

127. *Id.*

128. LEWIS, *supra* note 27, at 77–78.

129. *See id.* at 104–05.

130. *See id.*

131. Gretchen Morgenson & Louise Story, *Banks Bundled Bad Debt, Bet Against it and Won*, N.Y. TIMES, Dec. 23, 2009, <http://www.nytimes.com/2009/12/24/business/24trading>.

bets that CDOs would fail “while also pushing for riskier assets to go inside them.”¹³² Journalist Michael Lewis refers to these bets as the “Big Short”¹³³—basically, a giant collective wager that the housing market would fail.¹³⁴

Other firms and insurance companies took these bets, collecting lucrative premiums and fees, because the possibility of home prices drastically falling, of “triple-A” mortgage bonds defaulting, and of established firms such as Lehman Brothers and AIG going under, was unthinkable. As before, firms defended their positions in swaps and Synthetic CDOs as a means of diffusing risk and hedging their own bets.¹³⁵ A frequent refrain to wary outsiders looking in¹³⁶ was that the securities were simply misunderstood.¹³⁷ In reality, institutions had inextricably linked themselves with the fate of the subprime market, and every firm connected to it; it was a “tangled hairball of risk” that necessarily turned the failure of one firm into the failure of many.¹³⁸

html (describing the Securities and Exchange Commission investigation of Goldman Sachs and whether securities laws were violated by firms “creat[ing] and [selling] these mortgage-linked debt instruments and then [betting] against the clients who purchased them”). The S.E.C. has recently proposed rules that would end this practice. Prohibition Against Conflicts of Interest in Certain Securitizations, 76 Fed. Reg. 60,320 (Sept. 28, 2011) (to be codified at 17 C.F.R. pt. 230).

132. Jake Bernstein et al., *The Timeline of Magnetar’s Deals*, PROPUBLICA, April 9, 2010, <http://www.propublica.org/special/the-timeline-of-magnetars-deals>.

133. The “short” investors in a swap deal were those betting that the underlying bond would default. FCIR, *supra* note 13, at 142. Michael Lewis’s recent book, *The Big Short*, tells the story of the Subprime Crisis from the perspective of those that “shorted” the housing market. See generally LEWIS, *supra* note 27.

134. See LEWIS, *supra* note 27, at 256. As time went on and more firms became entangled in the looming crisis, a growing worry to those shorting the housing market was not that their bets were wrong, but rather all too right; if the risk of failure spread too far, the firms on the losing side of the bet would be in no position to pay their debts. That is, if the “entire financial system” went under, the winning bets would be worthless. (“I said to my mother [in 2007], ‘I think we might be facing something like the end of democratic capitalism,’” said [one short-side investor]. ‘She just said, ‘Oh Charlie,’ and seriously suggested I go on lithium.’) LEWIS, *supra* note 27, at 160.

135. See, e.g., Yalman Onaran, *Lehman Net Rises to Record on Stock-Trading Revenue*, BLOOMBERG, Mar. 14, 2007, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aT2_LrJmA8AQ (“We’ve done a very good job of managing the risks within our securitization business, including the active hedging strategies we employ to mitigate our risks.”) (quoting the Lehman Brothers CFO). Within 18 months, Lehman Brothers had filed for bankruptcy.

136. See, e.g., Evans, *supra* note 73 (“I have trouble understanding public pension funds’ delving into [toxic] tranches, unless they know something the market doesn’t know . . . [t]hat’s obviously a very risky play . . . [i]f there’s a meltdown, which I expect, it will hit those tranches first.”).

137. See, e.g., *id.* (“I think a lot of people are confused about [a CDO] and how it works.”) (quoting a Bear Stearns senior manager in 2007).

138. Mollenkamp & Ng, *supra* note 50.

Thus, an American housing bubble that could have cost billions was about to become a global financial crisis that cost trillions, due to the massive latent bets that the bubble was about to burst.¹³⁹

F. Meltdown

The concluding chapter of the subprime story ends as all asset bubble stories do—with prices that were once detached from reality, crashing back down.¹⁴⁰ The housing bubble peaked in 2006¹⁴¹ before several factors lead to a precipitous drop in prices. For one, the Federal Reserve had already begun raising interest rates in a belated effort to cool off the economy.¹⁴² And many of the existing ARM loans—those with interest rates that would adjust upward after two years—were finally adjusting.¹⁴³ At the same time, home prices kept rising, but average family income stayed the same; that is, homes had finally reached a point of basic unaffordability.¹⁴⁴ Amazingly, the rate of “first payment defaults” was increasing—meaning more borrowers could not even afford their very first mortgage payment.¹⁴⁵ Because homeowners were increasingly hard-pressed to make their monthly house payments, foreclosures escalated at a rapid rate—increasing by 75% from 2006 to 2007, and by another 81% from 2007 to 2008.¹⁴⁶ In 2008, 1 in 54 homes received a foreclosure filing.¹⁴⁷

139. LEWIS, *supra* note 27; *see also Taking Risk to Extremes*, BLOOMBERG BUSINESSWEEK, May 23, 2005, http://www.businessweek.com/magazine/content/05_21/b3934099_mz020.htm (“Any unraveling of CDOs ‘has the potential to be extremely messy’ . . . if things do go awry, the ripples may spread worldwide.”); INT’L SWAPS AND DERIVATIVES ASSOC., INC., ISDA MARKET SURVEY (2010), *available at* <http://www.isda.org/statistics/pdf/ISDA-Market-Survey-annual-data.pdf> (showing that there was approximately \$60 trillion in outstanding credit default swaps in 2007); *Credit Default Swaps*, *supra* note 95 (“As a result, the losses produced by the end of the housing bubble were multiplied manyfold, as the issuers of swaps found themselves faced with huge liabilities they had not prepared for.”).

140. *See* Erik F. Gerding, *The Next Epidemic: Bubbles and the Growth and Decay of Securities Regulation*, 38 CONN. L. REV. 393, 397 (2006).

141. Press Release, Standard & Poor’s, National Trend of Home Price Declines Continued into the First Quarter of 2008 According to S&P/Case-Shiller Home Price Indices (May 27, 2008), *available at* http://www2.standardandpoors.com/spf/pdf/index/CSHomePrice_Release_052703.pdf (showing the S&P/Case-Shiller Home Prices Indices from 1988–2008).

142. BOARD OF GOVERNORS OF THE FEDERAL RESERVE, *supra* note 8 (showing an increase in the Federal Funds rate from 1.25% on Jun. 30, 2004 to 5.25% on Jun. 29, 2006).

143. *See* FCIR, *supra* note 13, at 217.

144. *See id.* at 87.

145. *Id.* at 243.

146. Press Release, RealtyTrac, U.S. Foreclosure Activity Increases 75 Percent in 2007 (Jan. 30, 2008), *available at* <http://www.realtytrac.com/content/press-releases/us-foreclosure-activity-increases-75-percent-in-2007-3604>; Press Release, RealtyTrac, Foreclosure Activity Increases 81 Percent in 2008 (Jan. 15, 2009), *available at* <http://www.realtytrac.com/content/press-releases/foreclosure-activity-increases-81-percent-in-2008-4551> [hereinafter Foreclosure Activity Increases].

147. Foreclosure Activity Increases, *supra* note 146.

Prior to this, in the boom years, construction companies were building homes at a record pace to keep up with demand.¹⁴⁸ But when record output combined with the drastic uptick in foreclosures, there was now a surplus of housing—more and more homes were sitting empty.¹⁴⁹ In other words, the overvaluation of housing had finally reached its limit. Supply had eclipsed demand, which meant that for homes to sell, prices would have to come down. The bubble was bursting.¹⁵⁰

Subprime borrowers were particularly hard hit by the increased foreclosures.¹⁵¹ Remember that many had taken subprime loans they could plainly not afford, based on hopes that prices would keep rising. So long as prices went up, the thinking went, increased equity in a home could be used to refinance and obtain a more affordable deal. That much was true. But what many did not consider or understand is what would happen if prices suddenly fell: they would lose the equity in their house, and have no chance of refinancing that unaffordable loan.¹⁵² For those that were “underwater” on their home loan—i.e., owing more on their mortgage than the home was now worth—many decided that the smart move was to just walk away from the loan, and suffer the credit consequences.¹⁵³ As a result, subprime loans defaulted at a much higher rate.¹⁵⁴ What made matters worse was that foreclosures caused by falling prices simply increased the housing surplus, which drove prices down even further. This self-perpetuating cycle quickly undid the gains of the bubble years: By 2009, with 40% of all ARM loans in delinquency,¹⁵⁵ homes in some cities had lost over half their value.¹⁵⁶

At this point, the crisis was significant, but limited to the housing market. What turned a single-sector emergency into a system-wide breakdown were the trillions of dollars worth of securities whose value depended on one thing: steady home prices.¹⁵⁷ As foreclosures rolled in,

148. BUREAU OF ECON. ANALYSIS, U.S. DEP'T OF COMM., VALUE ADDED BY INDUSTRY (2010), available at http://www.bea.gov/industry/gdpbyind_data.htm (showing statistics of “[construction] industry value added in current dollars and corresponding quantity and price indexes for 1998–2009”).

149. Foreclosure Activity Increases, *supra* note 146.

150. See FCIR, *supra* note 13, at 214–18.

151. *Id.* at 214–18.

152. See *id.* at 389–90.

153. See *id.* A ruined credit rating is probably the least-bad outcome for someone attempting a “strategic default”—in some states, lenders can obtain deficiency judgments against defaulting homeowners. Les Christie, *You Lost Your House—But You Still Have to Pay*, CNNMONEY.COM, (Feb. 3, 2010, 3:21 PM), http://money.cnn.com/2010/02/03/real_estate/foreclosure_deficiency_judgement.

154. Mortgage Bankers Ass'n/Haver Analytics, U.S. Mortgage Residential Delinquency Rates (2010), http://www.richmondfed.org/banking/markets_trends_and_statistics/trends/pdf/delinquency_and_foreclosure_rates.pdf.

155. FCIR, *supra* note 13, at 216.

156. *Id.* at 215.

157. *Id.* at 134.

the low-level triple-B tranches of mortgage backed securities were wiped out.¹⁵⁸ Consequently, CDOs—the “towers” made entirely of those toxic tranches—failed in turn, causing heavy losses to investors that had bought bonds that were putatively triple-A. In the fall of 2007:

Citigroup and Merrill Lynch reported the most spectacular losses, largely because of their extensive [CDO] businesses, writing down a total of \$23.8 billion and \$24.7 billion, respectively, by the end of the year. Billions more in losses were reported by large financial institutions such as Bank of America (\$9.7 billion), Morgan Stanley (\$10.3 billion), JP Morgan (\$5.3 billion), and Bear Stearns (\$2.6 billion). Insurance companies, hedge funds, and other financial institutions collectively had taken additional mortgage-related losses of about \$100 billion.¹⁵⁹

But tremendous post-bubble losses on subprime bonds and CDOs were not the finale of the subprime story. As the waves of subprime bond defaults rolled in from 2007–2008, the dormant credit default swap bets on these bonds were finally triggered.¹⁶⁰ Of all the collateral effects of the housing bubble bursting, this was the most frightening, as it came close to spiraling out of control. The near-failure of AIG illustrates this.

At that time, the notional value of all outstanding swaps was a staggering \$58.2 trillion.¹⁶¹ AIG’s own exposure was tremendous: it had sold nearly half a trillion dollars worth of swaps, \$64 billion of which were based on subprime bonds.¹⁶² As the subprime market plummeted, taking not just bonds but whole firms such as Bear Stearns¹⁶³ along with it, swap holders now had the right to come collect on the defaults. AIG was thus on the hook for billions of dollars of “collateral calls” that were impossible to keep up with.¹⁶⁴ Without the capital reserves to pay for its lousy bets, AIG took a massive hit, losing \$99.3 billion in 2008—a larger sum than its total profits from the previous seven years combined.¹⁶⁵

AIG narrowly avoided collapse in the fall of 2008 during one of the most turbulent weeks in U.S. financial history. On Monday, September

158. *Id.* at 256–65.

159. *Id.* at 256.

160. *See id.* at 292–309.

161. *Id.* at 50.

162. *Id.* at 50, 268.

163. In 2007, Bear Stearns was leveraged at close to a 38 to 1 ratio and had significant subprime holdings. After the bubble burst, it hemorrhaged nearly \$16 billion in liquidity in just the four days prior to its end. Notwithstanding the firm’s mismanagement, from 2000–2008, its “top five executives . . . took home over \$326.5 million in cash and over \$1.1 billion from stock sales, for more than a total of \$1.4 billion. This exceeded the annual budget for the SEC.” FCIR, *supra* note 13, at 280–91. Bear Stearns avoided bankruptcy only through a “fire sale” to J.P. Morgan that was engineered by the Federal Reserve. Robin Sidel et al., *J.P. Morgan Buys Bear in Fire Sale, As Fed Widens Credit to Avert Crisis*, WALL ST. J., Mar. 17, 2008, at A1.

164. FCIR, *supra* note 13, at 349.

165. *Id.* at 350 (“[AIG’s 1999–2007 profits] of \$66 billion would be dwarfed by the \$99.3 billion loss for this one year, 2008.”).

15, the crisis claimed Lehman Brothers, which filed for what would become the “largest, most complex” bankruptcy ever.¹⁶⁶ The Dow plummeted 500 points that day and “\$700 billion in value from retirement plans, government pension funds, and other investment portfolios disappeared.”¹⁶⁷ A private plan to save AIG then vaporized, as panicking firms opted to collect on their default swap bets rather than invest in AIG and take on even more subprime risk. That same day, Federal Reserve and Treasury Department officials worked late into the night, ultimately invoking the Federal Reserve power¹⁶⁸ to “bailout” AIG and stave off its rapidly approaching demise.¹⁶⁹ By Tuesday morning, AIG had found a savior: U.S. taxpayers.¹⁷⁰ To say that the world’s largest insurance company came close to insolvency is an understatement. Officials noted that “[AIG] could [have] run out of money quite soon, even within days.”¹⁷¹

Credit default swaps not only explain AIG’s rapid unraveling, but why its initial¹⁷² bailout of \$85 billion went directly to other financial firms; taxpayers were basically paying for AIG’s bad bets.¹⁷³ Had those bets not been paid, AIG would have certainly gone under too, and then, all the bets against AIG *itself* would have likewise been triggered. The failure of one firm, catastrophic enough in isolation,¹⁷⁴ would inevitably take others down with it. As Federal Reserve Chairman and Great Depression scholar Ben Bernanke described the situation:

September and October of 2008 was the worst financial crisis in global history, including the Great Depression. If you look at the firms that came under pressure in that period . . . only one . . . was not at serious risk of failure So out of maybe the 13, 13 of the most important financial institutions in the United

166. *Id.* at 339–40 (“In the main bankruptcy proceeding, about 66,000 claims—exceeding \$873 billion—have been filed against Lehman as of September 2010.”). The cost of the bankruptcy proceeding *itself* is verging on \$1 billion. *Id.*

167. *Id.* at 339.

168. 12 U.S.C. § 343 (2006).

169. FCIR, *supra* note 13, at 349.

170. *Id.* at 350.

171. *Id.* at 344–52.

172. A total of \$182 billion of taxpayer money was ultimately given to AIG. *Id.* at 350.

173. See, e.g., Dominic Rushe, *How Goldman Sachs Gained from Bailout of AIG*, THE GUARDIAN, Jan. 27, 2011, <http://www.guardian.co.uk/business/2011/jan/27/goldman-sachs-received-aig-bailout-cash>.

174. The failure of AIG would have been particularly devastating, due to its size—it had over \$1 trillion of assets—and its interconnections with the global economy. FCIR, *supra* note 13, at 344, 347, 349.

States, 12 were at risk of failure within a period of a week or two.¹⁷⁵

Therefore, though taxpayer bailouts were odious to nearly everyone involved,¹⁷⁶ they were necessary to prevent a domino effect of cascading swap payouts and bankruptcies, and a global economic catastrophe on par with the Great Depression.¹⁷⁷

And that is the story of the Subprime Crisis.

In the aftermath of the crisis, Congress wrote prolific legislation to prevent a similar meltdown. One such reform was the Housing and Economic Recovery Act of 2008.¹⁷⁸ Its scope was far-reaching; its measures included creating a new regulator for Fannie Mae and Freddie Mac,¹⁷⁹ actions to stem the tide of foreclosures,¹⁸⁰ and improving mortgage loan disclosure requirements.¹⁸¹ Title V of division “A” of the Housing and Economic Recovery Act is the SAFE Act,¹⁸² and it addresses the widespread fraud committed by mortgage brokers during the growth of the housing bubble.¹⁸³

III. “JUST SIGN HERE”: MORTGAGE ORIGINATION FRAUD DURING THE CRISIS

The first book I picked up [in the prison library] was a real estate book . . .

—Michael Rowsey¹⁸⁴

A. Some Definitions

The SAFE Act imposes heightened standards on the mortgage broker industry in order to prevent fraud. But what exactly is a mortgage broker? A broker is in a sense a middleman between a potential home-

175. *Id.* at 354.

176. *See, e.g., id.* at 351 (“[AIG executives] have handed me a bag of sh*t.”) (quoting Treasury Secretary Tim Geithner on the AIG bailout).

177. *See id.* at 353–54.

178. Roger Runningen, *Bush Signs Measure for Homeowners, Fannie, Freddie (Update2)*, BLOOMBERG, July 30, 2008, <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=am2yQYThqmxQ>.

179. Federal Housing Finance Regulatory Reform Act of 2008, Pub. L. No. 110-289, §§ 1101–18, 122 Stat. 2654, 2659–88 (2008).

180. Foreclosure Prevention Act of 2008, Pub. L. No. 110-289, §§ 2001–2150, 122 Stat. 2654, 2830–48 (2008).

181. Mortgage Disclosure Improvement Act of 2008, Pub. L. No. 110-289, §§ 2501–03, 122 Stat. 2654, 2855–57 (2008).

182. Secure and Fair Enforcement for Mortgage Licensing Act of 2008, Pub. L. No. 110-289, §§ 1501–17, 122 Stat. 2654, 2810–24 (2008).

183. *Id.* § 1502, 122 Stat. 2654, 2810–11.

184. Michael Rowsey was a convicted killer who later became a mortgage broker. Cary Spivak, *Criminal Past No Barrier to Mortgage Field: Ex-cons Who Got Loan-Originating Licenses Commit Scores of Frauds that Cost Customers Millions*, MILWAUKEE-WISCONSIN J. SENTINEL, Mar. 14, 2009, <http://www.jsonline.com/watchdog/watchdogreports/41270712.html>.

owner and a lender: “an individual who takes a residential mortgage loan application . . . and offers or negotiates terms of a residential mortgage loan for compensation or gain.”¹⁸⁵ Note that bank employees can perform the functions of a broker too. These employees are usually called “loan officers.”¹⁸⁶

So mortgage brokers are in the business of negotiating a home loan, for a price. Buying a home is a transaction of great magnitude, as there are relatively few six-figure contracts the average American will enter into during her life—except for her mortgage. Because of this, it would be reasonable to expect that mortgage brokers, as orchestrators of these deals, would be subject to some regulations. But before the SAFE Act, this was not always the case.¹⁸⁷ Brokers are regulated at the state level, and not uniformly.¹⁸⁸ As a result, regulations during the bubble “[ran] the gamut between strict and lax—or nonexistent.”¹⁸⁹ For example, in Florida, there was no licensing requirement to work as a certain type of mortgage broker.¹⁹⁰ And when there were no regulations in place, it created a “crime-facilitative environment” in which the risks of mortgage fraud became far greater.¹⁹¹

Mortgage fraud is “the intentional misstatement, misrepresentation, or omission by an applicant or other interested parties, relied on by a lender or underwriter to provide funding for, to purchase, or to insure a mortgage loan.”¹⁹² The FBI divides mortgage fraud into two basic types: fraud for property, and fraud for profit.¹⁹³ The former is the per-

185. 12 U.S.C. § 5102(3)(A) (Supp. III 2009).

186. This article will maintain this language throughout, referring to bank-employed “brokers” as loan officers, and non-bank brokers as brokers. They perform the same function, but the key distinctions that must be kept in mind are whom each of them work for, and what regulations they are subject to.

187. Amy Hoak, *New Rules for Mortgage Lenders*, WALL ST. J., Aug. 1, 2010, <http://online.wsj.com/article/SB128061231943822865.html>.

188. *Id.*

189. *Id.* (quoting Bill Howe, President of the National Association of Mortgage Brokers).

190. In Florida, mortgage “originators . . . perform the same job as mortgage brokers but are not bound by the same rules.” Matthew Haggman et al., *Thousands with Criminal Records Work Unlicensed as Loan Originators*, MIAMI HERALD, August 29, 2011, <http://www.miamiherald.com/static/multimedia/news/mortgage/originators.html> [hereinafter *Thousands with Criminal Records*]. As for the licensing rules that did apply to Florida mortgage brokers, they were largely unenforced by state regulators. See *infra* Part VI.B.

191. FCIR, *supra* note 13, at 161 (“Lax or practically non-existent government oversight [of brokers] created what criminologists have labeled ‘crime-facilitative environments,’ where crime could thrive . . .”) (quoting Henry N. Pontell, professor of criminology at the University of California, Irvine).

192. James Smith, *The Structural Causes of Mortgage Fraud*, 60 SYRACUSE L. REV. 473, 477 (2010).

193. CRIMINAL INVESTIGATIVE DIV., FBI, MORTGAGE FRAUD REPORT 2006 (2006), available at <http://www.fbi.gov/stats-services/publications/mortgage-fraud-2006> [hereinafter 2006 MORTGAGE FRAUD REPORT].

petration of fraud in order to obtain a place to live.¹⁹⁴ In the latter, the pretense of obtaining housing is used to dupe a bank into extending credit.¹⁹⁵ Con artists take the cash, but have no intention of actually occupying the house.¹⁹⁶

These two categories of fraud can be broken down into several sub-categories.¹⁹⁷ First, there is misrepresentation of income, assets, or debts.¹⁹⁸ This occurred frequently in “liar loan”¹⁹⁹ situations. A potential borrower would give a phony representation of his financial health in order to be approved for a loan.²⁰⁰ A similar tactic is using forged or fraudulent “W-2s, tax returns, verifications of deposit; verifications of rent; credit reports; and forged signatures on loan documents.”²⁰¹ Again, this is used to obtain approval for a loan to a questionable borrower that a lender would have otherwise refused.²⁰² Other schemes include: occupancy fraud, in which a borrower misrepresents an intention to reside in a home; appraisal fraud; identity theft; “straw” purchasing; and, “flipping.”²⁰³

The common thread with all of these kinds of fraud is that they are used to induce a bank to make a loan that it would have otherwise refused.²⁰⁴ Given this commonality, it is not hard to see why mortgage fraud was one of the direct causes of the Subprime Crisis—it masked risks at the earliest stage of home lending.

If a bank lends money to someone who had to lie about his finances in order to obtain it, the loan is necessarily going to be riskier than it appears. For one thing, there is a hidden risk of default. After all, the loan will not be structured based on the borrower’s real financial situation, but his fictitious one, which contains “embellish[ed] income and conceal[ed] debt.”²⁰⁵ The bigger those misrepresentations are, the less affordable the loan will truly be, and the greater the risk of default—a risk that is hidden to the lender. Furthermore, typical creditor strategies that are used to ameliorate the dangers of lending to riskier borrowers, such as higher interest rates, would be less likely to be used if the homeowner is lying about his creditworthiness.

194. FINANCIAL CRIMES ENFORCEMENT NETWORK (FINCEN), MORTGAGE LOAN FRAUD: AN UPDATE OF TRENDS BASED UPON AN ANALYSIS OF SUSPICIOUS ACTIVITY REPORTS 4 n.5 (2008) [hereinafter FINCEN].

195. *Id.*

196. *Id.*

197. *Id.* at 12.

198. *Id.*

199. *See supra* p. 133 and notes 55–58.

200. *See FCIR, supra* note 13, at 110–11.

201. FINCEN, *supra* note 194, at 12.

202. *See id.*

203. *Id.* at 12–14. “Flipping” involves purchasing a property at a low price, obtaining a fraudulent appraisal for a much higher value, and then selling the property to a straw buyer for a substantial profit. *Id.* at 6 n.6.

204. *See Smith, supra* note 192, at 477–78.

205. FBI, 2009 MORTGAGE FRAUD REPORT “YEAR IN REVIEW” (2009) [hereinafter 2009 MORTGAGE FRAUD REPORT].

Securitization and default swaps only magnified the inherent risk in loans that were obtained through fraud—risks of default hidden by fraud would now spread throughout the financial system. When loans appear safer than they are, the bonds they go into are more likely to be highly rated by credit agencies, and investors seeking safety are more likely to invest in them. Institutions selling swaps for those bonds are essentially betting that the bonds will not default, without knowing that the underlying loan was made to someone who was actually very likely to default. And, if a fraudulent loan did in fact default, the original lender would typically have to buy the loan back through a “repurchase agreement,” and would be stuck with a non-performing or worthless asset.²⁰⁶ This placed further stress on banks’ balance sheets, and the market.²⁰⁷ Chris Swecker, an FBI assistant director, testified before Congress in 2004 that

[t]he potential impact of mortgage fraud on financial institutions and the stock market is clear. If fraudulent practices become systemic within the mortgage industry and mortgage fraud is allowed to become unrestrained, it will ultimately place financial institutions at risk and have adverse effects on the stock market.²⁰⁸

In sum, to help prevent another global crisis, it is crucial to prevent fraud at the origination stage, as the costs of fraud are no longer limited to a local bank. Securitization and derivatives spread unseen risks of default throughout the financial system, and these systemic risks are ultimately borne by taxpayers who must pay for bailouts. To this end, the SAFE Act focuses on mortgage brokers—one of the many actors who committed fraud during the crisis. Evaluating whether this focus is justified requires a look at those actors, and examining who committed the most fraud.

B. Who Commits Mortgage Fraud?

In 1970, Congress passed the Bank Secrecy Act.²⁰⁹ One of its requirements is that banks file “Suspicious Activity Reports” (SARs) with the Financial Crimes Enforcement Network (FinCEN).²¹⁰ Among the

206. Congressional Testimony, Chris Swecker, Assistant Director, Criminal Investigative Division, FBI, Before the House Fin. Services Subcommittee on Housing and Community Opportunity, Oct. 7, 2004, available at <http://www2.fbi.gov/congress/congress04/swecker100704.htm>.

207. *Id.*

208. *Id.*

209. *Timeline, 1970–Present*, FINCEN, http://www.fincen.gov/statutes_regs/bsa/bsa_timeline.html (last visited Oct. 9, 2011).

210. 31 U.S.C. § 5318(g) (2006).

suspected activities that bank employees can report are the various types of mortgage fraud.²¹¹ Thus, SAR data and analyses provide a useful source for examining the “trends and patterns shown in . . . suspected mortgage loan fraud,” including statistics on who bears responsibility for it.²¹²

In general, the perpetrators of the mortgage fraud are (1) the borrowers themselves, and (2) “industry insiders, including mortgage brokers, lenders, appraisers, underwriters, accountants, real estate agents, settlement attorneys, land developers, investors, builders, and bank and trust account representatives.”²¹³ An April 2008 FinCEN analysis of mortgage fraud SAR trends sheds light on which of the foregoing players—borrowers and the various “industry insiders”—were responsible for mortgage fraud.²¹⁴ The results of that report show that borrowers and brokers commit substantially more acts of fraud than loan officers.²¹⁵ In fact, among all perpetrators of mortgage fraud, loan officers commit the least amount.²¹⁶

The report examines mortgage fraud SARs from April 1, 2006 to March 31, 2007.²¹⁷ During 2006 alone, banks filed 37,313 SARs for mortgage fraud.²¹⁸ 1,769 of these were used to analyze various aspects of mortgage fraud, including who participated in it.²¹⁹

The FinCEN report first compares the two basic fraud categories, and how frequently the various participants were involved in it.²²⁰ *Figure 1* shows the percentage of borrowers, brokers, and loan officers “in SARs describing fraud for profit” and for housing.²²¹

Participant	Fraud for Profit	Fraud for Housing
Borrower	60.66%	87.06%
Mortgage Broker	62.07%	58.55%
Loan Officer	2.35%	1.13%

Figure 1

211. See FINCEN, *supra* note 194.

212. *Id.* at 1.

213. *Id.* at 11 fig.6; 2009 MORTGAGE FRAUD REPORT, *supra* note 205.

214. See FINCEN, *supra* note 194, at 11 fig.6.

215. *Id.*

216. *Id.*

217. *Id.* at 3.

218. *Id.*

219. *Id.* at 9.

220. *Id.* at 38 figs.17 & 18.

221. *Id.*

The FinCEN report goes on, showing the percentage of reported participants in the various subcategories of fraud.²²² Those numbers are in *Figure 2*.

Participant	Misrep. of Income	Forged or Fraudulent Documents	Occupancy Fraud	Appraisal Fraud	Straw Buyers	Identity Fraud	Identity Theft	Flipping
Borrower	87.12%	83.06%	70.20%	39.22%	69%	95%	40.98%	58.33%
Mortgage Broker	64.13%	68.15%	61.96%	48.71%	66%	40%	63.93%	68.75%
Loan Officer	< 1%	2.22%	1.57%	2.59%	3%	< 1%	1.64%	2.08%

Figure 2

It is worth noting that mortgage broker companies are not required to report suspicious activity, because they are not “money transmitting business[es]” as defined by the Bank Secrecy Act.²²³ Thus, the extent of unreported mortgage fraud that occurred cannot be known for sure.²²⁴

The data makes it plain: Mortgage brokers and borrowers participated in far more fraud than loan officers. The percentage of reported loan officer participation in fraud never exceeds 3%, and for several types of fraud, is lower than 1%.²²⁵ On the other hand, brokers were involved in more than half of all suspected fraud reports.²²⁶ Borrower fraud was even more pervasive, sometimes reaching levels as high as 95%.²²⁷ The high rate of fraud among brokers in particular is not surprising when one considers the lack of regulation in the industry, and some of the less-than-reputable characters that were drawn to it as a result.²²⁸

222. FINCEN, *supra* note 194, at 11 fig.6.

223. 31 U.S.C. §§ 5330(d)(1)(A)–(C), 5313(g) (2006).

224. Pending federal regulations would require that mortgage brokers file SARs too, fixing this “regulatory gap.” Financial Crimes Enforcement Network: Anti-Money Laundering Program and Suspicious Activity Report Filing Requirements for Residential Mortgage Lenders and Originators, 75 Fed. Reg. 76,677 (Dec. 9, 2010) (to be codified at 31 C.F.R. pt. 103); Transfer and Reorganization of Bank Secrecy Act Regulations, 75 Fed. Reg. 65,806 (Oct. 26, 2010) (which moved the Bank Secrecy Act regulations from 31 C.F.R. pt. 103 to 31 C.F.R. ch. X).

225. FINCEN, *supra* note 194, at 38 figs.17 & 18.

226. *Id.*

227. *Id.* at 11 fig.6.

228. *See, e.g.*, Spivak, *supra* note 184.

C. The Appeal of a Low-Risk & High-Return Crime

What was it about the mortgage broker industry that led to so much fraud? Of the brokers who participated in fraud, FinCEN data “includes examples of brokers acting both as active participants in the reported fraudulent activity, and as intermediaries that did not verify information submitted on the loan application.”²²⁹ Active participation in fraud was a result of the ease of obtaining a broker license. Because criminal records did not stop someone from becoming a broker, criminals were naturally attracted to the profession; compared to other crimes, mortgage fraud is low-risk and high-return.²³⁰ Or, to put it bluntly, “[t]he attraction of mortgage lending to criminals is simple: ‘[i]t’s extremely lucrative and you are less likely to be prosecuted and less likely to be shot at.’”²³¹

Newspaper articles are replete with tales of criminals working as brokers during the housing bubble. For example, a *Milwaukee-Wisconsin Journal Sentinel* investigation showed that in 2008, at least 340 active Wisconsin mortgage brokers had convictions for felonies or misdemeanors.²³² These brokers had been involved in drug crimes, theft, burglary, and armed robbery.²³³ One individual was a cocaine dealer who transitioned into the mortgage fraud “business,” running a \$2 million fraud-for-profit scam subsequent to a prison stint. He later ended up back in prison after a conviction for two murders he committed before becoming a broker.²³⁴ This particular criminal-turned-broker “[saw] selling mortgages as a natural field for a drug salesman,” and Assistant U.S. Attorney Carol Kraft agreed:

Here’s an enterprise that can bring in big money if you can figure out how to manipulate it, and it’s fairly safe . . . [nobody is] going to come in and shoot you because they want your mortgage records—not like a drug dealer who is in a transaction that could go bad.²³⁵

The article notes that “the hurdles to entering the profession are relatively low . . . [e]ven criminals on probation can receive a license,” and that state regulations only required²³⁶ checking the applicant’s names against the state criminal databases, as opposed to the federal.²³⁷

A *Miami Herald* investigation reached similar conclusions.²³⁸ It discovered that in Florida from 2000–2007, 5,306 individuals with criminal

229. FINCEN, *supra* note 194, at 3.

230. Spivak, *supra* note 184.

231. *Id.* (quoting attorney Rachel Dollar).

232. *Id.*

233. *Id.*

234. *Id.*

235. *Id.* (internal quotation marks omitted).

236. *Id.* This was pre-SAFE Act.

237. *Id.*

238. *Thousands with Criminal Records*, *supra* note 190.

records became mortgage originators²³⁹—nearly two every day.²⁴⁰ Furthermore, incredibly, 2,201 of these originators had “committed financial crimes, such as fraud, money laundering, and grand theft.”²⁴¹ And the problem was not limited to small, fly-by-night operations: “in at least 30 companies with more than 50 employees,” over one in five originators had a criminal history.²⁴²

Joseph Falk, former head of the National Association of Mortgage Brokers—who unsuccessfully pushed for regulation of originators in 2002²⁴³—described the situation in Florida as “more than disappointing, it [was] embarrassing . . . [i]t was pretty easy for someone to enter the industry because there were no standards. If there’s no one policing, anyone who wanted to join the industry could do so.”²⁴⁴ He is right: in Florida, although regulations were in place for lenders and brokers, to be an originator, no license or background checks were required.²⁴⁵ Consequently, “[w]ithout any central registration and with no requirements for entry, loan originators with criminal histories [could] move from firm to firm without divulging their past.”²⁴⁶

D. A “Crime-Facilitative”²⁴⁷ Environment

The lack of broker regulation created an environment where “crime could thrive”²⁴⁸—which is exactly what happened during the bubble years. In 2004, the FBI diagnosed mortgage fraud as “an epidemic,” in response to a five-fold increase in open investigations. William Black,

239. There is some potentially confusing language here: in Florida, there is no licensing requirement for mortgage “originators.” Originators “perform the same job as mortgage brokers but aren’t bound by the same rules.” *Id.* However, as this article discusses later, the rules that applied to mortgage brokers were all but unenforced in Florida. So the easiest way to think of this is that Florida “originators” were the brokers for whom there was *no* licensing system, and Florida “brokers” were the brokers for whom a system existed, but was unenforced. Thus, the practical difference between “originators” and “brokers” was slight, if anything. *See infra* Part VI.B.

240. *Thousands with Criminal Records*, *supra* note 190.

241. *Id.*

242. *Id.*

243. Matthew Haggman, *Florida Regulators Shun Licensing for Loan Originators*, MIAMI HERALD: BORROWERS BETRAYED, <http://www.miamiherald.com/static/multimedia/news/mortgage/fight.html> (last visited Oct. 9, 2011) (“Falk, worried about a frenzy of fraud cases, said too many people were able to jump into the industry—including loan originators—without criminal background checks and competency exams.”).

244. *Thousands with Criminal Records*, *supra* note 190.

245. *Id.* As mentioned before and discussed more later, the licensing regime in place for brokers was basically unenforced by the Florida Office of Financial Regulation. Thus, in Florida during the boom, “brokers” and “originators” both performed the functions of brokers—and neither was subject to an effective state licensing system. *See infra* Part VI.B.

246. *Id.*

247. FCIR, *supra* note 13, at 160.

248. *Id.* at 161.

who analyzed patterns of crime during the S&L crisis as a banking regulator, cited an estimate that during the housing boom, 1.5 million loans made every year contained some kind of fraud.²⁴⁹ Interthinx²⁵⁰ analyzed a large sample of loans made from 2005–2007, and found that 13% contained fraud significant enough to “rescind the loan or demand a buy-back if it had been securitized.”²⁵¹ Its conclusion was that during just these two years, \$1 trillion worth of fraudulent loans were made, and that \$160 billion of these ended in foreclosure, at a cost of \$112 billion to the loan owners.

Mortgage fraud only sped up as the economy crumbled. In 2008, Fannie Mae demanded that banks such as Countrywide, Bank of America, and Citigroup repurchase \$550 million worth of fraudulent mortgages, and approximately \$650 million more in 2009.²⁵² The FBI concluded that worsening economic factors “fueled a rampant mortgage fraud climate fraught with opportunistic participants desperate to maintain or increase their current standard of living.”²⁵³ Its assessment was that mortgage fraud was an “escalating problem in the United States and a contributing factor to the billions of dollars in losses in the mortgage industry.”²⁵⁴

E. Uniform Regulations for Brokers Are Justified and Necessary

Rampant mortgage fraud was an integral part of the Subprime Crisis, and justifies the SAFE Act. As to the Act’s focus, the FinCEN data refutes the argument that loan officers, in addition to mortgage brokers, should be licensed under the SAFE Act. Borrowers participated in a great deal of the fraud that occurred during the subprime bubble, especially fraud for housing. However, of the industry insiders to participate in fraud, mortgage brokers were far and away the most involved. Loan officers, on the other hand, were among the least involved in the fraud—almost to the point of statistical insignificance. This is not to say that all loan officers were innocent,²⁵⁵ or that the other decisions made by banks and bank employees during the bubble were sensible—but between loan officers and brokers, the latter participated in far more mortgage fraud.

249. *Id.* at 160.

250. Interthinx “is a provider of proven risk mitigation and regulatory compliance tools for the financial services industry.” FBI, 2008 MORTGAGE FRAUD REPORT (2008) *available at* <http://www.fbi.gov/stats-services/publications/mortgage-fraud-2008> [hereinafter 2008 MORTGAGE FRAUD REPORT]. It has analyzed millions of mortgage applications with various fraud-detection technology. Notably, in 2008, nearly one quarter of the loans it analyzed had “high impact variances”—possible red flags for fraud. *Id.*

251. FCIR, *supra* note 13, at 160.

252. *Id.* at 161.

253. 2008 MORTGAGE FRAUD REPORT, *supra* note 250.

254. *Id.*

255. See FCIR, *supra* note 13, at 160–64. Nor does this mean that banks or bank employees did not commit acts of fraud unrelated to mortgage origination. In September of 2011 the Federal Housing Finance Agency sued 17 financial firms for securities fraud related to the securitization of subprime loans. Nelson D. Schwartz & Kevin Roose, *U.S. Sues 17 Mortgage Institutions*, N.Y. TIMES, Sept. 2, 2011, at B1.

The extent of criminal involvement in the mortgage industry not only explains the pervasive fraud committed by brokers, but points to a way to end it. Because of lax regulations—and in some states, no regulations—criminals were drawn to the mortgage industry, and the attraction had a natural upward effect on the volume of crime in mortgage origination. The regulatory proposals of the SAFE Act will operate to prevent criminals from entering into the industry, perpetrating fraud, and concealing risks of default that are ultimately borne by all of us through securitization and derivatives.

IV. THE SAFE ACT

One lesson from the crisis is the need for more effective systemic regulation. There has been a focus on who should exercise this responsibility. But the most critical question is what the systemic regulator should do . . . —not who, so much as how?

—Lloyd Blankfein, CEO, Goldman Sachs²⁵⁶

The fallout from the Subprime Crisis precipitated a flurry of press reporting and academic scholarship that attempted to get to the bottom of it.²⁵⁷ Congress was similarly motivated to pass a series of legislative reforms in response to the crisis. One component of that reform was the SAFE Act, which was passed in 2008 as a part of the larger HERA Act.²⁵⁸ The SAFE Act directly targets mortgage fraud—its stated goals are to “increase uniformity, reduce regulatory burden, enhance consumer protection, and reduce fraud” in mortgage lending.²⁵⁹ The law itself boils down to two components: (1) the establishment of a national federal database that would register all mortgage originators, whether they are brokers or bank employees,²⁶⁰ and (2) the creation of a mandatory state licensing regime for mortgage brokers.²⁶¹ This is an important distinction; both brokers and loan officers are required to federally register, but only brokers are required to be licensed.²⁶² Without a state license,

256. Lloyd Blankfein, Op-Ed., *To Avoid Crises, We Need More Transparency*, FIN. TIMES, Oct. 12, 2009, <http://www.ft.com/intl/cms/s/0/94c6ab6c-b763-11de-9812-00144feab49a.html>.

257. See, e.g., *The Reckoning Series*, N.Y. TIMES, http://topics.nytimes.com/top/news/business/series/the_reckoning/index.html (last visited Oct. 9, 2011) (a series of 19 articles written in 2008, each focusing on a different contributing cause of the crisis).

258. Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289 (2008).

259. 12 U.S.C. § 5101 (Supp. III 2009).

260. *Id.* §§ 5103(a), 5106(a)(1).

261. *Id.* §§ 5103(a), 5104, 5107.

262. *Id.* § 5102(11)(A)–(B) (“The term ‘State-licensed loan originator’ means any individual who . . . is a loan originator [and] is not an employee of . . . a depository institution.”); *id.* § 5103(a)(1).

brokers cannot practice in that state.²⁶³ Practicing as a broker without a license will at the very least subject an individual to “civil money penalties,”²⁶⁴ and many states (including Idaho and Washington) have gone beyond this by imposing criminal penalties.²⁶⁵

A. Federal Registration

The centerpiece of the SAFE Act is a national federal database for the entire mortgage loan industry: the Nationwide Mortgage Licensing System and Registry (NMLSR).²⁶⁶ For loan officers, registration is fairly simple: they are required to submit fingerprints to the FBI for criminal background checks, and “personal history and experience” information to the NMLSR.²⁶⁷ This includes: (1) basic information such as name, address, and social security number; (2) “[f]inancial services-related employment” history; (3) certain criminal convictions and civil judicial actions against them; and, (4) any financial regulatory actions taken against them.²⁶⁸ After registering with the NMLSR, loan officers are assigned a “unique identifier” that will “facilitate electronic tracking and uniform identification of, and public access to, the employment history of and publicly adjudicated disciplinary and enforcement actions against” that officer.²⁶⁹ By gathering this data, the registry keeps track of loan officers even if they switch companies or move to a different state. And if the loan officer has a less-than-reputable history, consumers and employers are protected through easy access to that information.²⁷⁰ As mentioned, in declining to impose stricter regulations on loan officers, financial regulators cited the fact that banks were already heavily regulated.²⁷¹ Brokers, on the other hand, were not—a discrepancy corrected by the Act’s second component.

B. State Licensing

Like loan officers, mortgage brokers must register with the NMLSR to practice in a state, and meet all the requirements above.²⁷² However,

263. *Id.* § 5103(a)(1)(B).

264. *Id.* § 5107(d)(5).

265. In Idaho, it is a felony to practice as an unlicensed broker, and in Washington, it is a misdemeanor. IDAHO CODE ANN. § 26-31-318 (Supp. 2011); WASH. REV. CODE § 19.146.110 (2010).

266. 12 U.S.C. § 5106.

267. *Id.* § 5106(a)(2).

268. 12 C.F.R. §§ 34.103(d)(1)(i)(A), (B), (D), .103(d)(1)(ii)–(v) (2011).

269. 12 U.S.C. § 5106(b)(1).

270. *Id.* § 5101(7). Consumers can log on to NMLS Consumer Access (<http://www.nmlsconsumeraccess.org>) to conduct a free search to determine if a broker is licensed in their state. A search can be done by “Name, Company, City, State, Zip Code, NMLS ID, and/or license number.”

271. Registration of Mortgage Loan Originators, 75 Fed. Reg. 44,656, 44,659 (Jul. 28, 2010) (to be codified at 12 C.F.R. pts. 34, 208, 211, 365, 563, 610, 741, 761).

272. Registration of Mortgage Loan Originators, 75 Fed. Reg. 44,656–57 (Jul. 28, 2010) (to be codified at 12 C.F.R. pts. 34, 208, 211, 365, 563, 610, 741, 761) (“The S.A.F.E. Act

instead of just collecting data and issuing a “unique identifier,” the SAFE Act requires much more of brokers: acquiring a state license in order to practice.²⁷³ This is accomplished by requiring every state to create its own licensing system.²⁷⁴ In order to be valid, the state-crafted system must conform to the minimum federal requirements.²⁷⁵ However, states are given leeway to create a system that regulates brokers more stringently.²⁷⁶ In other words, the SAFE Act sets a floor, but not a ceiling, for mortgage broker regulation. All states must regulate their brokers at a minimum uniform level, but those states that wish to regulate brokers more heavily can do so.²⁷⁷

“Backup authority” is vested in the U.S. Department of Housing and Urban Development (HUD) to create a backup licensing system.²⁷⁸ What this means is that HUD will look to see if a state’s licensing system comports with the SAFE Act.²⁷⁹ If it does, then HUD will do nothing. But if the state system is inadequate, then HUD will implement and administer an additional licensing system that that state’s brokers would have to be licensed under.²⁸⁰ A broker in a non-complying state would thus have to be licensed under both systems in order to do business.²⁸¹ In other words, HUD would not replace a deficient state system—it would just add an additional “state” system that the broker would have to comply with. But HUD did not have to do so—as of March, 2011, all fifty states have created SAFE Act-compliant systems.²⁸²

Although compliant state licensing systems can and do differ, all systems must have two basic components: prerequisites for obtaining a license, and required standards for keeping it.

specifically prohibits an individual from engaging in the business of residential mortgage loan origination without first obtaining and maintaining annually: (1) A registration as a registered mortgage loan originator and a unique identifier if employed by an Agency-regulated institution (Federal registration), or (2) a license and registration as a State-licensed mortgage loan originator and a unique identifier. The S.A.F.E. Act requires that Federal registration and State licensing and registration must be accomplished through the same online registration system, the [NMSLR] . . .”).

273. 12 U.S.C. § 5103(a)(1)(B).

274. *See id.* § 5107(a).

275. *Id.* § 5104 (discussing State license and registration application and issuance); *id.* § 5105 (discussing the standards for State license renewal).

276. *Id.* § 5105(a) (“The *minimum* standards for license renewal for State-licensed loan originators shall include the following . . .”) (emphasis added).

277. *See id.*

278. *Id.* § 5107(a).

279. *Id.*

280. *Id.*

281. *Id.* *See also Commentary on Model State Law*, HUD, <http://www.hud.gov/offices/hsg/rmra/safe/cmsl.cfm> (last visited Nov. 23, 2011).

282. DEPT OF HOUSING AND URBAN DEVELOPMENT, SECURE AND FAIR ENFORCEMENT FOR MORTGAGE LICENSING ACT REPORT TO CONGRESS 2010 iii (2010).

1. Getting and Keeping a Broker License

The requirements for obtaining a broker license under the SAFE Act are numerous. Before granting a license, a satisfactory licensing system will require that a broker:

- Provide fingerprints for criminal background checks;²⁸³
- Submit personal information, including “information related to any administrative, civil or criminal findings” and a credit report;²⁸⁴
- Have no prior license revocations;²⁸⁵
- Not have committed a felony in the past seven years, and never have committed a felony involving fraud, dishonesty, breach of trust, or money laundering;²⁸⁶
- Pass a test on ethics, mortgage origination law, fraud, consumer protection, nontraditional mortgage products (i.e., subprime loans), and fair lending;²⁸⁷
- Take 20 hours of classes,²⁸⁸ including three hours covering federal regulations, three hours of ethics training (which must cover fraud, consumer protection, and fair lending), and two hours on unorthodox lending;²⁸⁹
- Demonstrate financial responsibility, character and fitness “such as to command the confidence of the community and to warrant a determination that [he] will operate honestly, fairly, and efficiently”,²⁹⁰ and,
- Meet a net worth or surety bond requirement, or pay into a state fund.²⁹¹

In order to renew the license, a broker must continue to satisfy the above requirements,²⁹² and must also complete at least eight hours of annual continuing education.²⁹³ This includes three hours on federal regulations, two hours of ethics, and two hours of “training related to lending standards for the nontraditional mortgage product marketplace.”²⁹⁴

These rules will have a direct positive impact on the mortgage broker industry. Requiring fingerprinting and background checks for brokers, and refusing to license those with criminal records, will dissuade

283. 12 U.S.C. § 5104(a)(1).

284. *Id.* § 5104(a)(2).

285. *Id.* § 5104(b)(1).

286. *Id.* § 5104(b)(2).

287. *Id.* § 5104(d)(1)–(2).

288. *Id.* § 5104(c)(1).

289. *Id.* § 5104(c)(1)(A)–(C).

290. *Id.* § 5104(b)(3).

291. *Id.* §§ 5104(b)(6), 5107(d)(6).

292. *Id.* § 5105(a)(1).

293. *Id.* § 5105(a)(2), (b)(1).

294. *Id.* § 5105(b)(1)(A)–(C).

criminals seeking a low-risk and high-return enterprise. For instance, had the licensing requirement been in place in Florida during the housing bubble—a state that formerly had no licensing requirement—2,201 ex-criminals would have never found work as originators.²⁹⁵ Had this happened nationwide, less mortgage fraud would have occurred,²⁹⁶ and fewer default-prone loans would have been unwittingly securitized. The crisis would have been diminished, at a savings to all taxpayers, where the buck ultimately stops.

The rules that screen out those who might perpetrate fraud are complemented by the education requirement. Mortgage lending is no longer a simple transaction with a local bank, accomplished with a “plain vanilla” 30-year fixed rate loan. Today’s mortgage products—especially those designed for the riskiest borrowers—are complex, and at times even baffling. This means that the broker is negotiating deals that are highly technical, potentially confusing, and fraught with serious personal, financial, and legal ramifications for the homeowner. A mortgage broker’s role in this deal is a fiduciary one,²⁹⁷ and his principal is usually the borrower.²⁹⁸ This means that in some cases a broker could be liable for the borrower’s mistaken assumptions regarding the deal.²⁹⁹ And at the very least, the broker is held to a standard of “highest good faith” and fair dealing.³⁰⁰

This is not to say that a broker is required to correct every incorrect belief that a borrower or lender has when entering into a deal—she is

295. The Miami Herald investigation found that 2,201 mortgage originators during 2000–2007 had prior convictions for “financial crimes, such as fraud, money laundering and grand theft.” Under SAFE Act licensing, a person with these prior convictions would not be able to obtain a license. *Thousands with Criminal Records*, *supra* note 190; 12 U.S.C. § 5104(b)(2).

296. See, e.g., Jack Dolan, Rob Barry & Matthew Haggman, *Ex-Convicts Active in Mortgage Fraud*, MIAMI HERALD: BORROWERS BETRAYED, <http://www.miamiherald.com/static/multimedia/news/mortgage/brokers.html> (last visited Oct. 9, 2011) (“State regulators allowed thousands of ex-convicts to enter a profession that gave them access to the most sensitive and personal financial information: credit cards, bank accounts and Social Security numbers . . . [t]hose criminals went on to commit nearly \$85 million in mortgage fraud. They stole their customers’ identities. They stole their money. They even stole their homes.”) [hereinafter BORROWERS BETRAYED].

297. *Armstrong v. Republic Realty Mortg. Corp.*, 631 F.2d 1344, 1348–50 (8th Cir. 1980) (holding that “[t]he agreement to act on behalf of the principal causes the agent to be a fiduciary,” and that by acting as the plaintiff’s agent, the defendant mortgage broker had fiduciary duties that extended beyond the duration of a loan commitment agreement). See also 18 AM JUR. PROOF OF FACTS 3D *Mortgage Broker Liability* § 10 (2010).

298. *Wyatt v. Union Mortg. Co.*, 598 P.2d 45, 50 (Cal. 1979) (“A mortgage loan broker is customarily retained by a borrower to act as the *[b]orrower’s agent* in negotiating an acceptable loan.”).

299. *Mortgage Broker Liability*, *supra* note 297.

300. *Wyatt*, 589 P.2d at 50.

not.³⁰¹ And brokers are not responsible for a borrower's failure to "take the normal steps to inform himself or herself about the mortgage loan transaction as it develops," or their indolence, ignorance, or inexperience.³⁰² But a basic education in ethics and exotic mortgage products will make it more likely that a broker will understand her basic duty to her principals, and how the loan being negotiated will function. And this can only increase the broker's odds of fulfilling her fiduciary duties: acting in fairness and good faith, and correcting mistaken assumptions about complex deals.

An argument that increased burdens on brokers are unfair does not hold up, given that brokers committed exponentially more fraud than loan officers. And as the next section will show, bank employees are already subject to an effective federal regulatory system. Although there is a sensible limit to any form of regulation, here, the SAFE Act merely places loan officers and brokers on a more level playing field. This is a sound policy: It makes little sense to require loan officers to jump through regulatory hoops for the sake of consumers, while exempting others who do the exact same job. By removing an unwise exemption based on form, not function, the licensing requirement of the SAFE Act will ensure that those seeking to exploit this regulatory gap—and homebuyers in the process—cannot do so.

V. THE OVERLAP BETWEEN THE SAFE ACT AND BANK REGULATION

To guard a title that was rich before, To gild refined gold, to paint the lily, To throw perfume on the violet, To smooth the ice . . . Is wasteful and ridiculous excess.

—Shakespeare³⁰³

The SAFE Act imposes a strict licensing requirement on brokers, but not on loan officers. Based on the findings of FinCEN and the FBI, it makes sense to impose regulations on brokers—they committed the vast majority of the mortgage fraud during the crisis. But does it make sense to exclude loan officers from the licensing requirement? One argument in favor of making this exception is that bank employees are already subjected to sufficient federal regulations. As we shall see, that argument is accurate. An examination of current bank regulations shows an extensive existing regime that duplicates the essential provisions of SAFE Act state licensing.³⁰⁴ In particular, its two main goals—giving

301. *Stetler v. Greenpoint Mortg. Funding Inc.*, No. 1:07cv0123, 2008 WL 192405, at 7 (E.D. Cal. Jan. 23, 2008) ("That [plaintiff] may not have understood the meaning of the documents, as he now seems to contend, does not render otherwise sufficient disclosures ineffective.").

302. *Mortgage Broker Liability*, *supra* note 297.

303. WILLIAM SHAKESPEARE, KING JOHN act 4, sc. 2.

304. Please note—the focus here is on the *existence* of duplicative bank regulations, not their *efficacy*. In other words, it is an operating assumption of this article that the bank

loan originators proper ethical and professional training, and preventing criminals from originating loans—are already accomplished by bank regulation. As a result, applying SAFE Act provisions to loan officers would be redundant and unnecessary.

A. An Overview of Bank Regulators

As one might expect, the regulation of the nation's banking system is complicated. There are five agencies³⁰⁵ that regulate five distinct groups of insured³⁰⁶ financial institutions: the OCC (national banks), the FDIC (state banks that are not members of the federal reserve), the Federal Reserve Board (state banks that are members of the federal reserve), the OTS (savings and loans), and the NCUA (credit unions).³⁰⁷ For the sake of brevity and simplicity, this article will explore the regulations and policies of a single regulator—the OCC. Because the Agencies maintain fairly uniform rules, a look at the OCC (or any Agency) is essentially a look at bank industry regulation in its entirety.³⁰⁸

B. A Brief History of the OCC

Tucked away in the “NEWS FROM WASHINGTON” of the New York Times, January 10, 1863, one can find the genesis of the Office of the Comptroller of the Currency.³⁰⁹ Although a discussion of “arrearages due to the army and navy” might not have been the most interesting dispatch from Washington that week,³¹⁰ it reflects the pressing economic conditions that led to the OCC. In short, Congress was in urgent need of

regulations were enforced and effective over the last decade—as evident from the low rates of fraud committed by loan officers. A detailed look at the enforcement of bank regulations is a topic for another article; for this one, it suffices that bank regulations that essentially recreate SAFE Act provisions are on the books, and that loan officer fraud was exceedingly rare.

305. This article refers to these five agencies as simply “the Agencies.”

306. Insured, that is, by the FDIC, which was established in the wake of the Depression-era bank runs. It insures consumer bank deposits in order to “maintain stability and public confidence in the nation's financial system.” *FDIC Mission, Vision, and Values*, FDIC, <http://www.fdic.gov/about/mission/index.html> (last visited Oct. 9, 2011).

307. 12 U.S.C. §§ 1, 1811(a), 321, 1462, 1752 (2006).

308. See, for example, the Bank Examination rules, which apply to all five banking regulators. 12 C.F.R. § 4.6 (2011) (OCC); *id.* § 563.171 (OTS); *id.* § 337.12 (FDIC); *id.* § 208.64 (Federal Reserve); *id.* § 790.2(b)(14) (NCUA).

309. *News from Washington*, N.Y. TIMES, Jan. 10, 1863, <http://www.nytimes.com/1863/01/10/news/washington-important-schemes-govern-ment-finance-secretary-chase-new-york.html?pagewanted=all>.

310. The most interesting dispatch that week was undoubtedly the scathing report on the resurgence of “rowdyism” in the House of Representatives, and “the feeblest and least noteworthy of the impotent junta of [its] members who seize every occasion to dampen loyal ardor.” *Id.*

cash to finance the Civil War, and a uniform national currency.³¹¹ A month later, the OCC was created as a bureau of the Treasury Department by the National Currency Act of February 25, 1863 (later known as the National Bank Act).³¹² The Act allowed for the establishment of “national banks”—banks that would be chartered by the federal government upon purchasing Treasury Bonds. The government’s coffers were quickly replenished, and a national banking system—with uniform rules and regulations for its members—was established.

Today, the OCC has one basic mission: supervision of the 1,678 U.S. national banks.³¹³ These banks range in size from small community banks to “trillion dollar ‘megabanks’” like Citigroup, Bank of America, Wells Fargo, and the like.³¹⁴ Federal branches of foreign banks are also under its supervision.³¹⁵ Not including those foreign entities, the assets of national banks total \$8.3 trillion, and they employ over a million people.³¹⁶ The legal structure for regulating such a complex cluster of institutions is correspondingly complex: the OCC’s supervisory authority is established in a web of statutes, regulations, guidelines, official statements, and examiner’s handbooks. What follows is a survey of that structure and the ways in which it accomplishes the two primary goals of SAFE Act licensing: ethics and training, and hiring standards for bank lending officers.

C. The Regulatory Architecture of the OCC

A legal analysis of any bank regulatory authority must begin with 12 U.S.C. § 1831p-1: the Standards for Safety and Soundness. This statute mandates that all Agencies devise “operational and managerial standards” for their respective banks.³¹⁷ The standards that an Agency develops must relate to “internal controls, information systems, and internal audit systems.”³¹⁸ Like all the Agencies, the OCC has met this requirement, and its basic standards for national banks can be found in Title 12 of the C.F.R., Part 30. These regulations provide that the OCC’s Safety and Soundness Standards will be issued by regulatory guideline,³¹⁹ and that various penalties are in store for national banks that fail to comply with those guidelines.³²⁰

311. OFFICE OF THE COMPTROLLER OF THE CURRENCY, NAT’L BANKS AND THE DUAL BANKING SYSTEM 7 (2003).

312. OCC ANN. REP. FISCAL YEAR 2007, at 7 (2008) [hereinafter 2007 OCC ANNUAL REPORT].

313. OCC ANN. REP. FISCAL YEAR 2008, at ii fig.2 (2009) [hereinafter 2008 OCC ANNUAL REPORT].

314. 2007 OCC ANNUAL REPORT, *supra* note 312 (report cover).

315. 2008 OCC ANNUAL REPORT, *supra* note 313, at 20.

316. *Id.* at ii fig.2.

317. 12 U.S.C. § 1831p-1(a) (2006).

318. *Id.* § 1831p-1(a)(1)(A).

319. 12 C.F.R. § 30.2 (2011).

320. *Id.* § 30.5.

The Safety and Soundness guidelines that national banks must adhere to are three appendices to Part 30—the Interagency Guidelines Establishing Standards for Safety and Soundness,³²¹ the Interagency Guidelines Establishing Information Security Standards,³²² and the OCC Guidelines Establishing Standards for Residential Mortgage Lending Practices.³²³ The first guideline contains a variety of standards for national banks, but the standards that relate to Internal Controls are key. These state that national banks “should have internal controls and information systems that are appropriate to the size of the institution and the nature, scope and risk of its activities.”³²⁴ Furthermore, those banks should have “an internal audit system that is appropriate to the size of the institution . . . and that provides for . . . [q]ualified persons” to work for it.³²⁵ The Guideline on Residential Mortgage Lending goes further, and states that certain types of loans may “be susceptible to abusive, predatory, unfair or deceptive practices.”³²⁶ It counts negative amortization loans and “liar loans” as among these.³²⁷ And therefore, when offering these products to consumers “who are not financially sophisticated, have language barriers, or are elderly, or have limited or poor credit histories, are substantially indebted, or have other characteristics that limit their credit choices,” national banks must “exercise enhanced care” and “apply appropriate heightened internal controls.”³²⁸ These two guidelines and their requirements for internal controls are what give the OCC the authority to require that banks have ethics and training programs (more on that shortly).

A quick word on how the OCC (and all Agencies) examine a bank’s Safety and Soundness: All insured banks must be evaluated by bank examiners.³²⁹ These examiners check on large and midsize banks at least once a year, and assess their capitalization, internal controls, and other areas of potential risk.³³⁰ For smaller banks, these exams must occur every 18 months.³³¹ The OCC has additional “authority to conduct more frequent” examinations, and does.³³² In addition to the approximately 1,400 community bank examiners employed by the OCC, over

321. *Id.* §§ 30.2, 30 app. A.

322. *Id.* §§ 30.2, 30 app. B.

323. *Id.* §§ 30.2, 30 app. C.

324. *Id.* § 30 app. A, at Part II.A.

325. *Id.* § 30 app. A, at Part II.B.3 (emphasis added).

326. *Id.* § 30 app. C, at Part III.B.

327. *Id.* § 30 app. C, at Part III.B.2, .7.

328. *Id.* § 30 app. C, at Part III.C.

329. 12 U.S.C. § 1820(b) (2006).

330. See generally Lawrence G. Baxter, *Administrative and Judicial Review of Prompt Corrective Action Decisions by the Federal Banking Regulators*, 7 ADMIN. L.J. OF AM. U. 505 (1994).

331. 12 U.S.C. § 1820(d)(4) (2006).

332. 12 C.F.R. § 4.6(c) (2011); 2008 OCC ANNUAL REPORT, *supra* note 313, at 13.

450 “resident examiners . . . work full-time, year-round” and regulate the nation’s 17 largest banks.³³³ Thus, at the megabanks, the examination of their Safety and Soundness is not only on-site, but “continuous.”³³⁴

If an examiner concludes a national bank has not met OCC Safety and Soundness standards, the bank must submit an acceptable plan to correct the problem.³³⁵ If the bank’s plan is unacceptable or is simply not submitted, the OCC can penalize the bank in several ways. These include restriction of asset increases, ordering an increased ratio of equity to assets, or, in a broad grant of power, any other action the OCC “determines will better carry out” its purpose.³³⁶ Furthermore, the Safety and Soundness standards authorize action under § 1831o(f)(2)(C) to restrict the interest rates that the institution pays on deposits.³³⁷

That is the basic architecture of OCC bank supervision: a statute that requires standards, regulations that place those standards in guidelines, examinations to check on bank compliance, and penalties for those that do not comply. To find provisions that duplicate the ethics and training requirements of the SAFE Act, one needs to dig a little deeper—to the handbooks that the OCC gives its examiners.

1. The Examiner’s Handbook: Ethics and Training

When evaluating national banks, OCC examiners operate according to the Examiner’s Handbooks.³³⁸ These clarify the meanings of broad terms in the Safety and Soundness guidelines and give examiners direction on how to assess bank compliance. These Handbooks are available on the OCC website,³³⁹ and one in particular requires that national banks have ethics and training programs in place: the Handbook on Internal Control.³⁴⁰

The Internal Control Handbook states upfront that “[e]ffective internal controls are the foundation of safe and sound banking,” and goes on to “discuss[] the characteristics of effective controls.”³⁴¹ For one thing, “every effective control system should have [a] control environment,” an

333. 2008 OCC ANNUAL REPORT, *supra* note 313, at 12–13.

334. *Id.* at 13.

335. 12 U.S.C. § 1831p-1(e)(1)(A) (2006).

336. *Id.* § 1831p-1(e)(2).

337. *Id.* § 1831o(f)(2)(C).

338. Also known as “Comptroller’s Handbooks.” *See, e.g.*, OFFICE OF THE COMPTROLLER OF THE CURRENCY, COMPTROLLER’S HANDBOOK: LARGE BANK SUPERVISION 1, 8 (2010) (“This booklet explains the [OCC’s] philosophy and methods . . . for supervising the largest and most complex national banks . . . Using the [handbook] assessment standards as a guide, an examiner obtains both a current and prospective view of a bank’s risk profile and determines its overall condition.”).

339. OFFICE OF THE COMPTROLLER OF THE CURRENCY, <http://www.occ.gov/publication/publications-by-type/comptrollers-handbook/index-comptrollers-handbook.html> (last visited Oct. 9, 2011).

340. OFFICE OF THE COMPTROLLER OF THE CURRENCY, COMPTROLLER’S HANDBOOK: INTERNAL CONTROL (2001) [hereinafter INTERNAL CONTROL].

341. *Id.* at 1.

element of which is having bank personnel with “integrity, ethics, and competence.”³⁴² This squarely comports with the Guidelines Establishing Standards for Safety and Soundness, which require that a bank’s internal audit systems provide for “qualified” employees.³⁴³

What factors will an OCC examiner consider to determine if a national bank’s employees are “qualified,” and if its internal controls satisfy the Safety and Soundness requirements? The Handbook prescribes a method: To analyze the “Quality of Internal Control,” the examiner will “[a]ssess the effectiveness of the control environment” by considering “[t]he integrity, ethics, and competence of personnel.”³⁴⁴ Furthermore, she shall “determine whether codes of conduct or ethics policies exist.”³⁴⁵ The examiner must also ask:

- “[Has the bank established] audit or other control systems . . . to periodically test for compliance with codes of conduct or ethics policies?”³⁴⁶
- “Do [bank] audit or other control system personnel routinely review policies and training regarding ethics or codes of conduct?”³⁴⁷

The Handbook also provides examiners a sample questionnaire for questioning the bank’s CEO.³⁴⁸ Questions include:

- “What written board-approved policies and procedures addressing . . . ethics/conduct are in place?”³⁴⁹
- “How do you ensure you have trained and qualified employees, including back-up employees, for all risk-taking activities and positions in the bank?”³⁵⁰
- “Does [an internal audit] scope include an assessment of risk and internal control? Is compliance with established ethics/conduct policies periodically tested?”³⁵¹

When subprime lending is involved, the standards for the bank are raised.³⁵² To offer certain ARM loans in a “safe and sound” manner, banks “should develop strong control systems to monitor whether actual

342. *Id.* at 5–6.

343. 12 C.F.R. § 30 app. A, Part II.B.3 (2011).

344. INTERNAL CONTROL, *supra* note 340, at 20.

345. *Id.* at 22.

346. *Id.*

347. *Id.*

348. *Id.*, app. A at 37–41.

349. *Id.* at 37.

350. *Id.* at 39.

351. *Id.* at 40.

352. Statement on Subprime Lending, 72 Fed. Reg. 37,569, 37,574 (Jul. 10, 2007).

practices are consistent with their policies and procedures . . . [i]mportant controls include establishing appropriate criteria for hiring and training loan personnel.”³⁵³

All of these factors go into the examiner’s assessment of “the overall effectiveness and adequacy of the [bank’s] internal control.”³⁵⁴ After evaluating the factors, the examiner will deem the bank’s internal controls as strong, satisfactory, or weak.³⁵⁵ If the examiner identifies risks that are “significant enough to merit bringing them to the board’s attention,” she will do so.³⁵⁶ In such a case, the examiner’s final report will include the bank’s plan for corrective action, and the time frame in which it must occur.³⁵⁷ As mentioned, failure by the bank to correct the deficiency can lead to all sorts of nasty penalties.³⁵⁸

This system is admittedly more flexible than the SAFE Act—banks are not commanded to have ethics and training programs in place; rather, they are compelled to, as the lack of these programs is a crucial detrimental factor in an examiner’s evaluation, and could activate the prompt corrective-action “tripwire” and concomitant penalties.³⁵⁹ But this article assumes that this system of placing the burden on banks works, because fraud was so rampant among brokers—but not loan officers. The OCC database lists only three Safety and Soundness enforcement actions since 1987;³⁶⁰ in all likelihood, this is because national banks—some of them under continuous supervision by resident examiners—have abided by the Standards, which include ethics and training. The Agencies themselves have agreed with this conclusion: “[We] decline to impose [SAFE Act licensing requirements on banks] . . . [We] note that these institutions already are subject to extensive Federal oversight, including regular on-site examination of their mortgage lending activities.”³⁶¹

Based on the current system, and the conclusion of the Agencies, requiring that loan officers undergo SAFE Act ethics and educational training would be redundant, and is thus unnecessary.

2. More Statutes, and Hiring Standards

As for hiring standards, a different (and mercifully simpler) set of statutes forbids insured banks from hiring persons with criminal rec-

353. *Id.*

354. INTERNAL CONTROL, *supra* note 340, at 33.

355. *Id.* at 34.

356. *Id.* at 10, 14–15.

357. *Id.* at 34–35.

358. *See supra* notes 336–37 and accompanying text.

359. *See* INTERNAL CONTROL, *supra* note 340, at 2–3. *See also* Baxter, *supra* note 330.

360. OFFICE OF THE COMPTROLLER OF THE CURRENCY, <http://apps.occ.gov/EnforcementActions> (select “Safety and Soundness” from the “Actions Against Institutions” drop-down menu, then select search) (last visited Oct. 9, 2011).

361. Registration of Mortgage Loan Originators, 75 Fed. Reg. 44,656, 44,661 (Jul. 28, 2010) (to be codified at 12 C.F.R. pts. 34, 208, 211, 365, 563, 610, 741, 761).

D. The Current Bank Regulatory System is Enough

The argument that banks already are “subject to a Federal regime of examination and supervision” and “extensive Federal oversight” is correct.³⁶⁸ The OCC, like all of the Agencies, regularly examines banks to ensure they are being operated safely and soundly. The Safety and Soundness Standards that banks are held to set minimums for ethics, employee competence, and hiring. And the Standards are not empty threats, as the penalties for noncompliance can be harsh.

Thus, while the claim that “bank employees were equally responsible for the crisis” might be accurate—after all, banks did underwrite and securitize the loans—this is only true as to the entire crisis, and its other components. The claim that bank employees were equally culpable for mortgage fraud in particular is just not true. Most likely, existing regulations are to thank for this. And because the SAFE Act licensing regulations basically duplicate current bank regulations, it is wise to apply those regulations only to brokers—not loan officers.

VI. IDAHO VS. WASHINGTON BROKER LICENSING

Idaho’s overall economic health and its housing industry are interdependent. Without a stable economy, the housing industry suffers and, without a stable housing market, Idaho’s economy cannot fully recover.

—Lawrence Wadsen, Idaho Attorney General³⁶⁹

Like all other states, Idaho and Washington have created broker licensing systems that conform to the SAFE Act’s minimum requirements.³⁷⁰ This includes the prerequisites for licensing and requirements for keeping a license. However, as mentioned, as long as these minimum standards are met, states have the freedom to craft licensing systems as they see fit. Washington has chosen to make its licensing regime stricter than Idaho’s in two significant ways: tougher standards regarding prior convictions, and mandatory standards for broker companies. These differences should add up to a more effective regulatory system, at a negligible cost to the industry; Idaho and its homebuyers would benefit from a similar system.

368. Registration of Mortgage Loan Originators, 75 Fed Reg. 44,656, 44,659 (Jul. 28, 2010) (to be codified at 12 C.F.R. pts. 34, 208, 211, 365, 563, 610, 741, 761).

369. OFFICE OF THE ATTORNEY GENERAL, STATE OF IDAHO, ATTORNEY GENERAL’S REPORT ON THE IDAHO HOUSING CRISIS AND HOW STAKEHOLDERS CAN FACILITATE COOPERATIVE SOLUTIONS 14 (2011).

370. See *State Licensing*, NMLS RESOURCE CENTER, <http://mortgage.nationwideliceningsystem.org/slr/Pages/default.aspx> (last visited Oct. 9, 2011).

A. Prerequisites for Obtaining a License

The SAFE Act presents several obstacles to obtaining a broker license in the first place. One of these is refusing to license individuals who have certain criminal histories. The minimum requirement is that states cannot license any person who has committed a felony within seven years, or has ever committed a felony involving “an act of fraud, dishonesty, or a breach of trust or money laundering.”³⁷¹ Idaho adopted this focus on felonies as required, but went no further.³⁷² On the other hand, Washington opted for a stricter approach, stating that, in addition to felonies, you are not eligible for a broker license if you have “been convicted of a gross misdemeanor involving dishonesty or financial misconduct” within seven years.³⁷³

The wisdom of this choice is apparent when one considers the panoply of Idaho misdemeanors involving financial fraud and deceit. Because Idaho limits its focus to prior *felonies*, persons can obtain a mortgage broker license in Idaho notwithstanding convictions for the following *misdemeanors*: Fictitious Stock Subscription;³⁷⁴ Exhibition of False Papers to Public Officials;³⁷⁵ Computer Crime;³⁷⁶ False Statement by Commission Merchant, Broker, Agent, Factor or Cosignee to Principal or Cosignor;³⁷⁷ Fraudulent Use of Financial Transaction Card or Number;³⁷⁸ Unauthorized Factoring of Credit Card Sales Drafts;³⁷⁹ and Receiving or Possessing Fraudulently Obtained Goods or Services,³⁸⁰ among others. Given the SAFE Act’s clear policy of barring entry to those with a past history of fraud and financial crime, it is illogical to allow, for example, an individual convicted of a past false statement while a broker to then become a licensed mortgage broker—simply because the fraudulent act was only a misdemeanor.

The only decent argument against this—that it could unfairly deny those with a checkered past the opportunity to become a broker—is defeated by Washington’s choice to place a time limit on the restriction. Much like the mandatory SAFE Act prohibitions on felonies, the Washington restrictions for gross misdemeanors only apply to those with convictions within the last seven years.³⁸¹ This strikes a proper balance between the need to prevent those more likely to commit fraud from be-

371. 12 U.S.C. § 5104(b)(2) (Supp. III 2009).
372. IDAHO CODE ANN. § 26-31-306(1)(b) (Supp. 2011).
373. WASH. REV. CODE § 19.146.310(1)(d)(i) (2010).
374. IDAHO CODE ANN. § 18-1901 (2004).
375. *Id.* § 18-1902.
376. *Id.* § 18-2202.
377. *Id.* § 18-3105.
378. IDAHO CODE ANN. § 18-3124 (Supp. 2011).
379. IDAHO CODE ANN. § 18-3125A (2004).
380. *Id.* § 18-3127.
381. WASH. REV. CODE § 19.146.310(1)(d)(i) (2010).

coming brokers, and the desire to provide employment to those whose criminal pasts are behind them. Idaho homebuyers would be well-served by a similar, balanced prohibition.

B. Idaho's Optional Broker Company Standards

In addition to the requirements imposed on individual brokers, Idaho and Washington both require that broker companies be licensed in order to do business.³⁸² At face value, the standards of the two systems are very similar. However, the drafting of the Idaho statute could rob its system of its potential effectiveness. The statute seems to give the Director of the Idaho Department of Finance discretion to grant a broker company license, even if an applicant fails to meet listed prerequisites. Thus, Idaho's broker license system—despite its apparent similarity to Washington's—is less effective, due to its discretionary nature.

In order to do business as a broker company in Washington, a license is required.³⁸³ To obtain a license, certain standards must be met by the license applicant, the company's principals, and the company's "designated broker."³⁸⁴ These standards are similar to the individual broker license requirement in that the above individuals must not have had a license revocation, or "been convicted of a gross misdemeanor involving dishonesty or financial misconduct or a felony within seven years of the filing of the present application."³⁸⁵ Furthermore, they must not have violated any of the licensing act rules, or provided unlicensed mortgage loan modification services in the last five years.³⁸⁶ Finally, the company's designated broker must: "[have] at least two years of experience in the residential mortgage loan industry; [and have] passed a written examination whose content shall be established by rule of the director."³⁸⁷ It is important to note that these licensing requirements are not optional. The Director of the Washington State Department of Financial Institutions "*shall* issue and deliver a [broker company] license to an applicant, *if* . . . the director makes the following findings."³⁸⁸ The effect of this non-permissive language is that, if the requirements are not met, the director cannot issue the license, and a mortgage broker company in Washington may not legally do business.³⁸⁹

At first glance, Idaho's mortgage broker company law looks quite similar. Found in Part 2 of the Idaho Residential Mortgage Practices Act, it requires a license for mortgage broker companies to operate in the state, and that applications be sent to the Director of the Idaho De-

382. IDAHO CODE ANN. § 26-31-201 to -211 (Supp. 2011); WASH. REV. CODE § 19.146.0201–15 (2010). Both state acts refer to broker companies as simply "mortgage brokers." This language is avoided in order to prevent confusion.

383. WASH. REV. CODE § 19.146.200(1) (2010).

384. *Id.* § 19.146.210(1).

385. *Id.* § 19.146.210(1)(c)–(d).

386. *Id.* § 19.146.210(1)(g)–(h).

387. *Id.* § 19.146.210(1)(e).

388. *Id.* § 19.146.210(1) (emphasis added).

389. *See id.* § 19.146.210(2).

partment of Finance.³⁹⁰ The Director has the authority to deny license applications when, among other things:

The financial responsibility, character and fitness of the license applicant . . . [is] not such as to warrant belief that the business will be operated honestly and fairly within the purposes of this part; [t]he qualified person in charge of the applicant's places of business does not have a minimum of three (3) years' experience in residential mortgage brokering or mortgage lending; [t]he applicant has been convicted of any felony, or of a misdemeanor involving any aspect of the financial services business, or a court has accepted a finding of guilt on the part of the applicant of any felony, or of a misdemeanor involving any aspect of the financial services business; [t]he applicant has had a license, substantially equivalent to a license under this part and issued by any state, denied, revoked or suspended under the law of such state; . . . [t]he applicant or any partner, officer, director, manager, member, employee or agent of the applicant has violated any state or federal law, rule or regulation pertaining to the financial services industry³⁹¹

These requirements are sound. Forbidding dubious individuals with a history of financial crime from running broker companies goes to the heart of preventing the company-wide corruption and illegal schemes that occurred during the bubble.

However, certain language in this section might prevent it from being fully effective. Unlike the corresponding Washington law, the Idaho broker company licensing requirements are not mandatory. Idaho's law states that "[t]he director *shall* receive [license applications]," and that those applications "*shall* be filed through the NMLSR," and "*shall* be accompanied [by an application fee]."³⁹² However, the mandatory language vanishes in the very next subsection; it states that "[a]n application for license *may* be denied if the director finds that [any of the prerequisites are not met]"³⁹³ This makes the foregoing prerequisites for broker company licensing not really prerequisites at all. Instead, they are conditions that allow the Director to deny an application. There are no current regulations that clarify the mechanics of license issuance; but based on the language of the statute, one reasonable interpretation is this: Unless the Director chooses to act, an applicant will be given a license—despite violations of the listed broker company standards.

390. IDAHO CODE ANN. § 26-31-206(1) (Supp. 2011).

391. *Id.* § 26-31-206(2)(a)–(d), (g).

392. *Id.* § 26-31-206(1) (emphasis added).

393. *Id.* § 26-31-206(2) (emphasis added).

A brief return to the story of the Subprime Crisis illustrates the problems that this could cause. As mentioned, in Florida, during the Subprime Crisis, there was no requirement that a mortgage originator obtain a license.³⁹⁴ On the other hand, mortgage brokers were required to be licensed.³⁹⁵ However, much like the current Idaho broker company law, denial of a Florida broker license application was at the discretion of the Florida Office of Financial Regulation (OFR).³⁹⁶ Indeed, a prior criminal record involving “fraud, dishonest dealing, or any act of moral turpitude” would not be an absolute bar to licensure; instead, it would be “a ground for denial of licensure.”³⁹⁷ The obvious question then becomes: Did Florida regulators exercise their authority to deny licenses based on these grounds for denial? The *Miami Herald* investigation of mortgage fraud in Florida provides an eye-opening look.

The *Herald* found that in Florida during the Subprime Crisis, OFR regulators let virtually all applicants with criminal records become brokers. Before the bubble years, the OFR had created its own internal standards to buttress the discretionary statutory standards, and held to them.³⁹⁸ But as the real estate industry took off, these standards eroded. From 2000–2007, 4,065 broker applicants in Florida were guilty of crimes of “fraud, dishonest dealing, and ‘moral turpitude.’”³⁹⁹ These included 2,821 financial crimes, including larcenies, frauds, racketeering, burglaries, forgeries, and bank robberies, and 1,588 crimes of moral turpitude, such as assault and batteries, drug dealing, and homicides.⁴⁰⁰ All of these applicants could have been rejected by the OFR; it had valid “ground[s] for denial” of a license in every instance.⁴⁰¹ But incredibly, of the 4,065 applicants, 4,036 received licenses—the agency denied only 29 applications.⁴⁰² That is, 99.3% of applicants with criminal records constituting grounds for denial were licensed. Even more incredible was that, of those licensed, “at least 20 brokers [got] to keep their licenses even after committing the one crime that seemed sure to get them banned from the industry: mortgage fraud.”⁴⁰³

What was the ultimate result of the OFR declining to exercise its statutory right to deny broker applications? The example of Scott Almeida is illustrative. After leaving federal prison in 2002, Almeida applied to become a Florida mortgage broker.⁴⁰⁴ He admitted on his license application that he had a prior conviction for cocaine trafficking.⁴⁰⁵ The OFR had grounds to deny his application, but instead,

394. *Thousands with Criminal Records*, *supra* note 190.

395. *Id.*

396. FLA. STAT. ANN. §494.0062(2) (West 2006) (amended 2006) (repealed 2011).

397. *Id.*

398. *Ex-Convicts Active in Mortgage Fraud*, *supra* note 296.

399. *Id.*

400. *Id.*

401. *Id.*

402. *Id.*

403. *Id.*

404. *Id.*

405. *Id.*

[t]hey asked for a character reference: He gave them a note from his mom. They said he needed a reputable supervisor for his practice: He chose a guy he met in the prison visitor room. They asked for a copy of the court file but never demanded the police report, which shows that he had been caught with a small arsenal of assault rifles and ammunition, in addition to the cocaine. Their background investigation complete, regulators circled “approved” at the bottom of the screening checklist, collected a \$215 license fee and looked the other way.⁴⁰⁶

Once admitted as a mortgage broker, Almeida spent the next three years on a mortgage fraud “crime spree.”⁴⁰⁷ He originated nearly \$3 million in fraudulent loans, and “fleeced 30 people—many of them elderly and disabled.”⁴⁰⁸ Notably, Almeida and his associates would target victims of Hurricane Charley.⁴⁰⁹ One such woman was promised a loan to help stave off foreclosure and repair hurricane damage.⁴¹⁰ Instead, Almeida walked away with \$50,000 of loan proceeds, and the fifty-four-year-old library assistant was left with a rotting porch, unfinished repairs, and a “30-year mortgage to pay.”⁴¹¹ The OFR was even given two subsequent warnings that Almeida was ripping off clients—but did nothing.⁴¹² Almeida’s scam continued until his eventual arrest by Florida police.⁴¹³ Unfortunately, Almeida’s case was not unique; the *Herald* uncovered many other examples of consumer-finance-related crimes committed by former criminals whose applications were approved by the OFR.⁴¹⁴

The utter failure of regulatory oversight in Florida was basically a worst-case-scenario event, and the author is not suggesting that the same would be inevitable in Idaho. Rather, it is a cautionary tale of what can happen when times are good, the economy is thriving, and mortgage broker applications are flooding in. Without mandatory standards set by statute, agencies might loosen their own internal

406. *Id.* Even the note from Mom should have given Florida regulators pause: “[My son] did something wrong that he is very sorry for. He has served his sentence Scott could have just given up to the fact that even if he passed the test, you might not allow him to have his license It took Scott three times [to pass the license test] but he passed and he didn’t give up. That should say something about Scott’s determination to better his life.” Letter from Almeida’s Mother to the OFR (June 1, 2002) (emphasis added), available at <http://www.miamiherald.com/static/multimedia/news/mortgage/almeidamother.html>.

407. *Ex-Convicts Active in Mortgage Fraud*, supra note 296.

408. *Id.*

409. Ivan Penn, *Loan Scam Hits Dozens*, ST. PETERSBURG TIMES, July 20, 2007, http://www.sptimes.com/2007/07/20/Hillsborough/Loan_scam_hits_dozens.shtml.

410. *Id.*

411. *Id.*

412. *Ex-Convicts Active in Mortgage Fraud*, supra note 296.

413. Penn, supra note 409.

414. See, e.g., *Ex-Convicts Active in Mortgage Fraud*, supra note 296.

standards. And this does not require any sort of nefarious intent on the part of regulators; a booming economy puts pressure on busy agencies to keep pace with demand, and standards that are optional or discretionary would naturally be the first to be relaxed or jettisoned. Today, in hindsight, it is obvious that the Florida language was insufficient—the criminal history requirements should have been mandatory, and not just “grounds” for license denial. But because the standards were optional, criminals were licensed en masse, vulnerable homeowners were preyed upon, and the ensuing foreclosures contributed to the wider crisis.

Fixing this potential problem for Idaho would be easy: change the permissive “may” of section 26-31-206(2) to a mandatory “shall.” Or at the very least, change the language, but reserve to the Director the power to grant a broker company license—despite an applicant not meeting the standards—only in “exigent” or “unusual” circumstances. This would give the Director freedom to choose whom to license, while preventing the potential repetition of other states’ mistakes.

With such a change, the statute would be more logical and effective, and would help protect Idaho’s homebuyers—the whole point of the SAFE Act.⁴¹⁵ Certain standards should be inflexible, and not be subject to loosening when market pressures are brought to bear. Unfortunately, discovering what standards fall into this category can require a crisis, and the benefit of hindsight. But having been through a major financial crisis, we have that benefit, and now know that criminal background standards need to be rigid. Of course, eliminating fraud altogether is impossible; but fixing the Idaho statutory language would help prevent another Florida situation from happening, before a future boom might cause us to forget that such situations can and do occur. Ideally, future Idaho homeowners will never be in the position of Floridians today: injured, looking backward, and wondering why a law was written the way it was.

In light of the role that mortgage fraud played in the Subprime Crisis, and the role that brokers played in mortgage fraud, the State of Washington’s increased licensing standards are justified, and should protect consumers accordingly. This is not to say that Idaho’s licensing system will be ineffective—in some respects it is tougher than the Washington system.⁴¹⁶ However, the differences in Washington’s licensing standards should discourage criminal entry into the mortgage business, and its homebuyers should enjoy a corresponding reduction in mortgage fraud. Because Idaho’s licensing standards can match up to Washington’s with some simple revision, Idaho legislators would be wise to do just that.

415. 12 U.S.C. § 5101(6) (Supp. III 2009).

416. A violation of the Idaho act is a felony, whereas a violation of the Washington act is only a misdemeanor. *Compare* IDAHO CODE ANN. § 26-31-318 (Supp. 2011), *with* WASH. REV. CODE § 19.146.110 (2010).

VII. CONCLUSION

Should home prices fall, we would have reason to be concerned about mortgage debt; but measures of household financial stress do not, at least to date, appear overly worrisome If lenders . . . continue their prudent lending practices, household financial conditions should be all the more likely to weather future challenges.

—Alan Greenspan, 2004⁴¹⁷

The day of reckoning is not now, but maybe five years from now.

—James W. Paulsen, 2004⁴¹⁸

The scariest days of the Subprime Crisis will eventually fade from memory, but its economic aftereffects linger on. Although a general consensus about the causes of the crisis has formed, the debate on its finer points continues.⁴¹⁹ Regardless of their positions in that debate, policy-makers are in obvious agreement as to the exigency of avoiding another crisis. Preventing financial crises altogether is likely impossible—the natural rise and fall of the markets, after all, is not going away anytime soon. But preventing a crisis on the same scale of the Subprime Crisis will surely be impossible if steps are not taken to address its root causes. That will not always be easy. For example, limiting the risks posed by exotic securities and derivatives will require delicate action. This is not just because of their inherent complexity, but because they serve important roles in modern markets, when functioning properly. Diffusing the dangers posed by these instruments while preserving their positive economic potential will require an elegant solution.

By comparison, fixing mortgage fraud is easy: hold brokers and loan officers to the same ethical and regulatory standards. Otherwise, con artists will gravitate toward an industry that lets them in, no questions-asked, and offers low-risk and high-return employment for those who perpetrate fraud on homeowners. This easy fix is largely accomplished by the SAFE Act, and states choosing to go beyond its minimum requirements should see a corresponding benefit. For Idaho in

417. Alan Greenspan, Chairman, Fed. Reserve Bd., Remarks at America's Community Bankers Annual Convention: The Mortgage Market and Consumer Debt (Oct. 19, 2004), available at <http://www.federalreserve.gov/boarddocs/speeches/2004/20041019/default.htm>.

418. Edmund L. Andrews, *Greenspan Shifts Views on Deficits*, N.Y. TIMES, Mar. 16, 2004, <http://www.nytimes.com/2004/03/16/business/greenspan-shifts-view-on-deficits.html>.

419. Two dissenting views on the causes of the crisis are included in the Financial Crisis Inquiry Report. The fundamental position adopted by the majority of dissenters on the commission is that “[w]e . . . reject as too simplistic the hypothesis that too little regulation caused the crisis, as well as its opposite, that too much regulation caused the crisis.” FCIR, *supra* note 13, at 414.

particular, a more effective system could be created with some minor tweaks to existing law.

Preventing mortgage fraud might seem like a narrow issue, with a narrow set of beneficiaries—it certainly did to many during the housing bubble.⁴²⁰ But that is not the case. Due to the end result of mortgage fraud when combined with other unchecked components, it is not just future homebuyers who have a vested interest in smart, effective regulation. The SAFE Act is a small step in the right direction for *all* Americans—because they not only suffer the brunt of financial disasters,⁴²¹ but will ultimately foot the bailout bill. Recent history has shown that when emerging threats to the financial system are underestimated, and a “day of reckoning” arrives, the duty to save the system falls to a generation of taxpayers. If these small preventive steps continue to occur, we might ensure that that generation is only our own, and not the next.

*Kale Gans**

420. FCIR, *supra* note 13, at 163 (“Michael B. Mukasey . . . U.S. attorney general from November 2007 to the end of 2008 told the Commission that he recalled ‘receiving reports of mortgage failures and of there being fraudulent activity in connection with flipping houses, overvaluation, and the like,’ and that he had ‘a dim recollection of outside people commenting that additional resources should be devoted’”).

421. GDP, employment rates, and home prices have all suffered tremendously in the wake of the Subprime Crisis. From 2007 to the first quarter of 2009, \$17 trillion in net household wealth was lost in the U.S.. FCIR, *supra* note 13, at 391.

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