Chapter 2

The Financial Crisis—Critical Events

§ 2:1 Introduction
§ 2:2 Time Line of the Crisis
§ 2:3 Details of Major Events
§ 2:3.1 Bear Stearns Liquidity Crisis and Merger with JPMorgan
§ 2:3.2 The IndyMac and Washington Mutual Failures and the Role of the Office of Thrift Supervision
§ 2:3.3 Conservatorship of Fannie Mae and Freddie Mac
§ 2:3.4 Too Big to Fail I: Lehman, Merrill, and AIG
§ 2:3.5 Too Big to Fail II: Citigroup and Bank of America

§ 2:1 Introduction

It is impossible to understand fully the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act")[1] without some reference to the events of 2008, which former Federal Reserve Chairman Alan Greenspan has termed "the most virulent global financial crisis ever."[2] Although reform of the U.S. financial regulatory system had been discussed for many years, the "Panic of 2008" was the catalyst for Congressional action. This Panic, however, was the culmination of a storm that had been quietly brewing for several years, hidden by a growing global economy and rapidly rising equity and commodity markets that were fueled by a considerable savings rate in certain parts of the world and loosened credit policies in the United States.

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1. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, H.R. 4173 (July 21, 2010) [hereinafter Dodd-Frank Act].
2. Alan Greenspan, *The Crisis*, BROOKINGS PAPERS ON ECON. ACTIVITY (Apr. 2010).

In retrospect, it is difficult to escape the conclusion that overly accommodative Federal Reserve monetary policy, entwined with bank underwriting standards that were as relaxed as bank risk management practices, as well as a booming securitization market, created the Housing Bubble that has become notorious for laying low so many financial institutions, large and small. Given the connection of the Financial Crisis to housing, we have begun the "Time Line of the Crisis" below in the summer of 2007, when the effects of the turn of the U.S. housing market first became clear.

§ 2:2 Time Line of the Crisis

Summer 2007

- Spike in early delinquencies of recent subprime mortgages.
- Standard and Poor's and Moody's Investor Services ("Moody's") downgrade over 100 bonds backed by second-line subprime mortgages, and place 612 securities backed by subprime residential mortgages on a credit watch.
- Countrywide Financial Corp. warns of "difficult conditions"; it is downgraded by Fitch Ratings and borrows the entire amount available in its credit lines with other banks.
- Bear Stearns liquidates two hedge funds that invested in various types of mortgage-backed securities.
- BNP Paribas halts redemptions on three investment funds.

Fall 2007

- Markdowns in the value of tens of billions of Mortgage Backed Securities (MBSs) and Collateralized Debt Obligations (CDOs).
- Mid September: First bank "run" in the United Kingdom occurs as depositors rush to withdraw money from Northern Rock, a U.K. bank that had invested significantly in the mortgage markets.

January 11, 2008

- Bank of America announces that it will purchase Countrywide Financial in an all-stock transaction worth approximately $4 billion.

February 21, 2008

- The U.K. government nationalizes Northern Rock.

March 14, 2008

- JPMorgan Chase & Co. announces it will acquire Bear Stearns. See section 2:3.1 below.

July 11, 2008

- The Office of Thrift Supervision (OTS) closes IndyMac F.S.B., which is placed into a Federal Deposit Insurance Corporation (FDIC) conservatorship. See section 2:3.2 below.

July 13, 2008

- The Federal Reserve Board (the "Federal Reserve") authorizes the Federal Reserve Bank of New York (FRBNY) to lend to Fannie Mae and Freddie Mac should lending become necessary.
- Treasury announces a temporary increase in the credit lines of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corp. (Freddie Mac), and a temporary authorization for the Treasury to purchase equity in either Government-Sponsored Enterprise (GSE) if needed.

July 15, 2008

- The U.S. Securities and Exchange Commission (SEC) issues an emergency order temporarily prohibiting naked short selling in the securities of Fannie Mae, Freddie Mac, and the commercial and investment banks that are primary dealers.

July 30, 2008

- President Bush signs into law the Housing and Economic Recovery Act, which among other provisions authorizes the Treasury to purchase GSE obligations and reforms the regulatory supervision of the GSEs under a new federal agency, the Federal Housing Finance Agency (FHFA). See section 2:3.3 below.

September 7, 2008

- Fannie Mae and Freddie Mac are placed into conservatorship by the FHFA. Treasury announces preferred stock purchase agreements between the Treasury/FHFA and Fannie Mae and Freddie Mac, a new secured lending facility available to the GSEs, and a temporary program to purchase MBSs from the GSEs.

September 15, 2008

- Lehman Brothers Holdings Inc. ("Lehman Brothers") files for Chapter 11 bankruptcy.
- The Federal Reserve authorizes an $85 billion loan for AIG under section 13(3) of the Federal Reserve Act.

- Bank of America announces its intent to purchase Merrill Lynch. See section 2:3.4 below.

September 17, 2008

- SEC temporarily bans short selling of stock of all companies in the financial sector.
- Barclays and Nomura Holdings agree to acquire portions of Lehman Brothers' businesses out of the Chapter 11 proceeding.
- Lloyds TSB Group plc acquires HBOS plc.

September 21, 2008

- Goldman Sachs and Morgan Stanley become bank holding companies.

September 25, 2008

- The OTS closes Washington Mutual Bank, and JPMorgan Bank engages in a purchase-and-assumption transaction for its assets.

September 28, 2008

- Fortis Bank S.A./N.V., a Dutch-Belgian banking institution, is nationalized.

September 29, 2008

- The United Kingdom confirms Bradford & Bingley is to be partially nationalized by the U.K. government and partially sold.
- The U.S. House of Representatives rejects Emergency Economic Stabilization Act (EESA).

September 30, 2008

- France, Belgium, and Luxembourg invest in Dexia.
- Ireland announces a comprehensive guarantee scheme for deposits in its major banks.
- The Dow falls 780 points.

October 3, 2008

- The EESA becomes law and establishes the $700 billion Troubled Asset Relief Program (TARP).

October 8, 2008

- The Federal Reserve agrees to buy up to $37.8 billion in investment grade fixed income securities from AIG in return for cash collateral.

- The U.K. government commits up to £50 billion for capital investments in U.K. banks.

October 12, 2008

- The Federal Reserve approves Wells Fargo/Wachovia merger in a transaction that does not require FDIC assistance, upending the previously announced acquisition of Wachovia by Citigroup.

October 13, 2008

- France, Germany, Spain, the Netherlands, and Austria commit €1.3 trillion to guarantee bank loans and take stakes in lenders.
- $57 billion U.K. government capital investment in the Royal Bank of Scotland Group plc, Lloyds, and HBOS.

October 14, 2008

- FDIC establishes Temporary Liquidity Guarantee Program guaranteeing the senior debt of all FDIC-insured institutions and their holding companies, as well as deposits in non-interest-bearing deposit transaction accounts.
- TARP Capital Purchase Program established by Treasury under EESA: $125 billion in funding to banks through preferred stock investments by Treasury.

October 16, 2008

- UBS AG reports that the Swiss government has taken a 9% stake in order to bolster its capital position.

October 28, 2008

- Treasury purchases $125 billion in preferred stock in eight U.S. financial institutions: JPMorgan Chase, Citigroup, Bank of America, Morgan Stanley, Goldman Sachs, Bank of New York Mellon, State Street Corporation, and Wells Fargo.

November 10, 2008

- Treasury announces $40 billion purchase of AIG preferred shares.
- FRBNY restructures AIG's credit facility and introduces two lending facilities.
- The Federal Reserve approves American Express and American Express Travel Related Services bank holding company applications.

November 14, 2008

- Freddie Mac submits capital request to Treasury.

November 17, 2008

- Capital Purchase Program expands to other U.S. banks.

November 23, 2008

- U.S. government announces a package of up to $306 billion of guarantees and $20 billion of capital for Citigroup.

November 25, 2008

- The FRB announces purchase of up to $600 billion of GSE housing-related obligations.

January 16, 2009

- Treasury, FRB, and FDIC announce additional support to Bank of America, and finalize terms of their guarantee agreement with Citigroup. See section 2:3.5 below.

§ 2:3 Details of Major Events

§ 2:3.1 *Bear Stearns Liquidity Crisis and Merger with JPMorgan*

The first casualty of the financial crisis was effectively Bear Stearns Cos. ("Bear Stearns"). Bear Stearns, formerly the nation's fifth largest investment banking firm, employed, prior to March 2008, approximately 14,000 employees worldwide and was a diversified financial services holding company doing business in institutional equities, fixed income, investment banking, global clearing services, asset management, and private client services. Along with many of its peers, Bear Stearns was heavily involved in various aspects of the housing market. It purchased and operated residential mortgage originators, and packaged and underwrote large pools of mortgages into MBSs.

Bear Stearns' problems began in 2007 as the U.S. housing market began to sour. Its asset management division managed two hedge funds, the High-Grade Structured Credit Strategies and High-Grade Structured Credit Strategies Enhanced Leverage Funds, that had invested heavily in previously highly rated CDOs linked to mortgages.[3] As market conditions for such CDOs worsened in the spring of 2007, the hedge funds were faced with investor redemption requests and margin calls that they could not meet.[4] Although Bear Stearns committed more than $1.6 billion to these two funds, the funds failed

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3. *See, e.g., Bear Stearns Letter Sent to Investors Last Night*, THE TELEGRAPH, July 18, 2007.
4. *Id.*

in July 2007.[5] In addition to raising questions about Bear Stearns' risk management function, this episode is also frequently cited as influencing the prohibition on fund sponsorship by banking entities contained in the Dodd-Frank Act's "Volcker Rule."

In March 2008, rumors began spreading among traders that European financial firms had ceased doing fixed income trades with Bear Stearns. A number of fixed income and stock traders in the United States reacted by stopping their trades as well. Soon, asset management companies and hedge fund clients did the same or demanded that Bear Stearns provide cash as collateral on trades with the firm, and withdrew cash from their accounts at Bear Stearns. Money market funds also reduced their holdings of short-term Bear-issued debt.[6]

When testifying before the Financial Crisis Inquiry Commission in May 2010, James Cayne, as had other former Bear Stearns executives, blamed market forces and financial panic for the failure of the firm, stating that:

> Despite the efforts we made prior to 2007 to reduce our exposure to the subprime sector, the scale of our activities in other sectors of the mortgage market caused widespread concerns about Bear Stearns' solvency. These concerns were unfounded. Our capital ratios and liquidity pool remained high by historical standards. Nevertheless, as a result of these rumors, during the week of March 10, 2008, brokerage customers withdrew assets and counterparties refused to roll over repo facilities. These events resulted in a dramatic loss of liquidity. The market's loss of confidence, even though it was unjustified and irrational, became a self-fulfilling prophecy.[7]

All these actions caused a major liquidity crisis at Bear Stearns, prompting Cayne to seek financing from JPMorgan Chase Bank on March 13, 2008. After discussions with the Federal Reserve Bank of New York, the Federal Reserve voted to use its emergency lending powers under section 13(3) of the Federal Reserve Act to offer Bear Stearns access to the discount window by means of an advance to JPMorgan Chase Bank.[8] At the same time, the Federal Reserve Bank of New York sought to broker a transaction whereby JPMorgan Chase Bank's parent, JPMorgan Chase & Co. ("JPMorgan"), which was itself healthy, would acquire Bear Stearns. On March 16, 2008, JPMorgan announced that it would purchase Bear Stearns in a stock-for-stock

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5. *Id.*
6. GARY SHORTER, CONG. RESEARCH SERV., BEAR STEARNS: CRISIS AND 'RESCUE' FOR A MAJOR PROVIDER OF MORTGAGE-RELATED PRODUCTS (updated Mar. 26, 2008).
7. Fin. Crisis Inquiry Comm'n (May 5, 2010) (testimony of James Cayne).
8. For a more detailed discussion, see *infra* chapter 3.

transaction valued at $2 a share, slightly over 1% of the $170 share price that Bear Stearns had fetched at a 2007 peak. This price would be renegotiated to $10 a share as a result of widespread anger by Bear Stearns shareholders, one-third of which were Bear Stearns employees.

The Bear Stearns "rescue" was a precedent for future transactions during the Panic of 2008—an acquisition of a significant failing firm by a larger, healthy financial firm, with the U.S. government sharing in the risk of loss—and has engendered significant criticism to this day. Critics of the regulators' actions have argued that Bear Stearns should have been allowed to fail, on the grounds that a failure would have imposed the necessary market discipline on financial institution creditors earlier in the crisis, would have sent a message that the government was not prepared to support the financial sector, and would not have had the same systemically dislocating effects as the failure of Lehman six months later.[9]

§ 2:3.2 The IndyMac and Washington Mutual Failures and the Role of the Office of Thrift Supervision

The next significant shoe to drop—and like Bear Stearns, a casualty of the housing market—was a far different institution, a retail bank supervised by the OTS. On July 11, 2008, in what was, at the time, the second largest bank failure in the United States, IndyMac Bank F.S.B. was seized by the OTS and placed into an FDIC conservatorship.[10] The failure of IndyMac signaled the beginning of a multitude of smaller bank failures to come—as of September 28, 2011, 384 banks had failed since September 1, 2008. The failure was also significant because of IndyMac's size and the resulting cost to the Deposit Insurance Fund, a cost of approximately $9 billion. In addition, in hindsight it became clear that the OTS had taken certain controversial actions during the events leading up to the failure, actions that brought increased scrutiny on the agency and provided arguments for the OTS's elimination, which ultimately was mandated by the bank regulatory reform provisions of the Dodd-Frank Act.[11]

By the time of its failure, IndyMac was one of the largest mortgage originators in the United States. Its failure was primarily due to its particular concentration of so-called "Alt-A" mortgages, which are mortgages that do not qualify for traditional GSE backing for various

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9. *See, e.g.*, Peter J. Wallison, *Ideas Have Consequences*, AEI ONLINE, May 2010.
10. Press Release, FDIC, FDIC Establishes IndyMac Federal Bank, FSB as Successor to IndyMac Bank, F.S.B. (July 11, 2008).
11. For a more detailed discussion of these provisions, see *infra* chapter 7.

reasons, including due to their lack of documentation.[12] According to the material loss review report from the Department of Treasury's Inspector General released in February 2009, IndyMac's aggressive growth strategy, use of Alt-A and other nontraditional loan products, insufficient underwriting, credit concentrations in residential real estate in the California and Florida markets, and heavy reliance on costly Federal Home Loan Bank funds and brokered deposits were the reasons for its demise.[13] IndyMac had poor underwriting standards and verification processes, and as a result many risky nontraditional loans were made to borrowers that simply could not afford them.[14]

The failure of the bank itself generated controversy and finger-pointing. When IndyMac was closed, the Director of the OTS, John Reich, stated that "This institution failed due to a liquidity crisis. Although this institution was already in distress, I am troubled by . . . interference in the regulatory process," referring to the June 26, 2008 release of a letter by New York Senator Charles Schumer, a senior member of the Senate Banking Committee, to the regulators expressing his concerns with the institution.[15] After the letter was released, worried depositors withdrew approximately $1.55 billion of deposits.[16]

Others, however, were of the view that the thrift was already headed for failure and it should have been subject to action by regulators much earlier in the process.[17] In addition, in the aftermath of the failure, certain actions by the OTS came to light that themselves were highly controversial. According to IndyMac's last 10-Q issued before its failure, the bank's risk-based capital ratio had dropped to 10.26% as of March 31, 2008, from 10.81% the previous quarter.[18] IndyMac

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12. Off. of the Inspector Gen., Dep't of Treasury, OIG-09-032, Safety and Soundness: Material Loss Review of IndyMac Bank, FSB (Feb. 26, 2009) [hereinafter Safety and Soundness: Material Loss Review of IndyMac Bank, FSB].
13. *Id.*
14. *Id.*
15. Press Release, OTS, OTS Closes IndyMac Bank and Transfers Operations to the FDIC (July 11, 2008).
16. Senator Schumer's release of his letter engendered criticism not just from a current regulator, but a former one. John D. Hawke, Comptroller of the Currency from 1998 to 2004, told the *American Banker*: "If Schumer continues to go public with letters raising questions about the condition of individual institutions, he will cause havoc in the banking system. Leaking his IndyMac letter to the press was reckless and grossly irresponsible. . . . What this incredibly stupid conduct does is put at risk the willingness of regulators to share any information with the [congressional] oversight committees." AM. BANKER, July 2, 2008.
17. Safety and Soundness: Material Loss Review of IndyMac Bank, FSB, *supra* note 12.
18. IndyMac Bancorp Inc., Report on Form 10-Q (May 12, 2008).

reported that the bank's risk-based capital was $47 million above the minimum required for this 10% mark; it did not, however, reveal that $18 million of that $47 million was actually a fiction, as that $18 million reflected a backdated capital contribution from its parent holding company. The OTS's Western Regional Director, Darryl Dachow, had permitted IndyMac to backdate this contribution, and it also became clear that the OTS had permitted backdating for at least six other institutions, and even directed the backdating on at least one occasion.[19]

The OTS's woes increased when, a little over two months later, Washington Mutual ("WaMu"), a $300 billion thrift and the sixth largest depository institution in the United States, failed. As was the case with Bear Stearns, JPMorgan Chase again came to the rescue, with its flagship bank, JPMorgan Chase Bank, N.A., engaging in an FDIC-assisted purchase and assumption transaction.[20] Unlike IndyMac, the failure did not result in a loss, much less a significant loss to the Deposit Insurance Fund,[21] but this did not prevent the OTS from coming under additional criticism. After a hearing on April 15, 2010, the U.S. Senate Permanent Subcommittee on Investigations sharply criticized the OTS for allowing WaMu to replace traditional low-risk thirty-year fixed loans with higher risk mortgages in 2005 and for continuing to give the thrift satisfactory CAMELS ratings despite examination findings of "less than satisfactory" underwriting standards, "higher than acceptable" underwriting errors, weak risk management controls, and a disturbing number of loans with false borrower information or loans that failed to comply with the bank's credit requirements.[22] The Permanent Subcommittee further noted that the OTS had limited the number of FDIC staff allowed on site at WaMu and rejected an FDIC request to review loan files for compliance on regulatory guidance on nontraditional mortgages, all at a time when WaMu was supplying fees to the OTS equaling between 12% to 15% of the OTS's budget.[23]

§ 2:3.3 Conservatorship of Fannie Mae and Freddie Mac

Notwithstanding Bear Stearns and IndyMac, most persons returning from the dog days of summer on Labor Day 2008 would have been

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19. Safety and Soundness: Material Loss Review of IndyMac Bank, FSB, *supra* note 12.
20. Press Release, FDIC, JPMorgan Chase Acquires Banking Operations of Washington Mutual (Sept. 25, 2008).
21. *Id.*
22. STAFF OF S. SUBCOMM. ON INVESTIGATIONS, 112TH CONG., WALL STREET AND THE FINANCIAL CRISIS: ANATOMY OF A FINANCIAL COLLAPSE (Apr. 13, 2011).
23. *Id.*

reasonable to be calm. On August 29, the Dow Jones Industrial Average closed at 11,543.55, the Nasdaq at 2,367.52, and the S&P 500 at 1,282.83. All this was to change, however, in the course of a month, by the end of which widespread financial panic had begun to set in. The first significant event of the month occurred on September 7, 2008, when the Director of the FHFA, James B. Lockhart III, with the support of Treasury Secretary Paulson and Federal Reserve Chairman Bernanke, announced that he was placing Fannie Mae and Freddie Mac into a FHFA conservatorship.[24]

Fannie Mae and Freddie Mac were the two most important GSEs in the United States, and, because of their significance to the U.S. housing market, two of the most important corporations in the country. Together, in 2008, they held or guaranteed $5.2 trillion of the United States' $12 trillion in mortgages; in the summer of 2008, their share prices had come under severe pressure due to investor perceptions that their capital was insufficient to withstand anticipated losses stemming from weaknesses in the U.S. housing market, declining almost by half in a week alone. In response, on July 13, 2008, Treasury Secretary Paulson announced a plan to shore up investor confidence in Fannie Mae and Freddie Mac: an increased credit line from Treasury and seeking legislative authorization for the Treasury to purchase equity in the GSEs; in addition, the Federal Reserve announced that it had granted the Federal Reserve Bank of New York the authority to allow the two GSEs to borrow from the discount window, if it became necessary.[25]

Notwithstanding these actions, and additional Congressional action at the end of July that created a new agency (the FHFA) to oversee Fannie Mae and Freddie Mac, by September the Bush Administration had determined that the two GSEs could not independently raise sufficient capital for future losses. The FHFA therefore placed the two institutions into conservatorship, assuming the power of Fannie and Freddie's boards of directors and management and replacing their chief executive officers.[26] Although such conservatorship has analogs in the receivership and conservatorship provisions of the Federal Deposit Insurance Act (FDIA) relating to failed banks, the Bush Administration's actions were by all accounts a massive government intervention in private industry, and one that was a precedent for more controversial interventions in other industries when the Financial Crisis deepened. Three other steps accompanied the FHFA's actions:

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24. Press Release, FHFA, Statement of FHFA Director James B. Lockhart (Sept. 7, 2008).
25. Press Release, Dep't of the Treasury, Paulson Announces GSE Initiatives (July 13, 2008).
26. Press Release, FHFA, Statement of FHFA Director James B. Lockhart (Sept. 7, 2008).

(1) Treasury entered into Preferred Stock Purchase Agreements, under which Treasury would ensure that each GSE maintained a positive net worth; under these agreements, existing common and preferred shareholders would bear losses ahead of the new senior government preferred shares; (2) Treasury established a new secured lending facility for the GSEs; and (3) Treasury initiated a temporary program to purchase Fannie Mae and Freddie Mac MBS.[27] By December 2009, Fannie Mae and Freddie Mac had tapped $111 billion of government assistance. On December 24, 2009, when "not even a mouse" was probably stirring in Washington, Treasury Secretary Geithner announced the Obama Administration's decision to allow an unlimited line of credit from Treasury to the two GSEs, which had lost a total of $188.4 billion over the preceding nine quarters.[28]

The Dodd-Frank Act takes no action with respect to Fannie Mae and Freddie Mac, deferring an ultimate solution for the two GSEs to another day.

§ 2:3.4 Too Big to Fail I: Lehman, Merrill, and AIG

One week after the announcement of the FHFA conservatorship for Fannie Mae and Freddie Mac, an even more extraordinary weekend of dealings occurred. Between the close of the markets on Friday, September 12 and their open on Monday, September 15, two of New York's most historic investment banking firms disappeared: Lehman Brothers Holdings Inc. ("Lehman") filed for bankruptcy protection, and Merrill Lynch ("Merrill") was swallowed up by Bank of America Corp. On September 16, the Federal Reserve Board announced that it was using its emergency section 13(3) powers to extend an $85 billion secured loan to American International Group, Inc. (AIG) with the U.S. Treasury also making a preferred stock investment.

The disparate treatment of the three firms in the course of a matter of days—Lehman declaring bankruptcy, Merrill being sold without government assistance to Bank of America, and the Federal Reserve's emergency loan to AIG—is another one of the most controversial aspects of the crisis.[29] Debates about the ability of the government and regulatory agencies to support a deal for Lehman will undoubtedly

27. *Id.*
28. Press Release, Dep't of the Treasury, Treasury Issues Update on Status of Support for Housing Programs (Dec. 24, 2009).
29. In the Lehman bankruptcy proceeding, Barclays Bank Plc, which had considered buying all of Lehman during the weekend of September 13–14, purchased Lehman's North American investment banking and trading divisions along with its New York headquarters building. Other parts of Lehman's business were sold out of the bankruptcy as well—Nomura Holdings acquired Lehman's trading franchise in the Asia Pacific region,

continue for years, but during the week of September 15 itself, it was all too clear what the effects of "failing" Lehman were—a rapid acceleration of the panic as credit markets seized, stock indices plummeted, and worries mounted about the viability of the two remaining stand-alone investment banks, Morgan Stanley and Goldman Sachs. Other attempts at government intervention were made: on September 17, the SEC banned naked short-selling in the stocks of financial companies,[30] and on September 21, Morgan Stanley and Goldman Sachs opened themselves to Federal Reserve supervision by converting each of their lead depository institutions to true "banks" and thereby becoming bank holding companies.[31]

As with other failures, the end of Lehman Brothers and Merrill had its root cause in housing. Lehman experienced extremely large losses from a very significant MBS portfolio; indeed, Lehman securitized more MBS than any other firm and maintained a large amount of those securities for its proprietary portfolio.[32] During the housing bubble, Lehman acquired several mortgage lenders, specializing in Alt-A lending, that caused large losses as well.[33] Similarly, Merrill was heavily involved in the mortgage-based CDO market, both in terms of underwriting CDOs and holding them on its books.[34] Merrill also purchased First Franklin Financial Corp., a large subprime lender, in December 2006, as part of a push into housing-related business.[35]

A second factor pointed to by commenters was the extent of leverage at both firms: both Lehman and Merrill were over 30-to-1 leveraged. A March 2010 report by a court-appointed examiner indicated that Lehman executives regularly used repurchase agreements at the end of each quarter to appear less leveraged, starting to use these transactions as early as 2001.[36] Commenters also criticized the SEC, which was the supervisor responsible for capital at both firms, for a

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including Japan, Hong Kong, and Australia, as well as Lehman's investment banking and equities businesses in Europe and the Middle East. Lehman's investment management business, including Neuberger Berman, was sold to its own management on December 3, 2008.

30. Press Release, SEC, SEC Issues New Rules to Protect Investors Against Naked Short Selling Abuses (Sept. 17, 2008).

31. Press Releases, Federal Reserve Board (Sept. 21, 2008).

32. *See, e.g.*, Abigail Field, *Lehman Report: The Business Decisions That Brought Lehman Down*, DAILY FIN., Mar. 14, 2010.

33. *Id.*

34. *See, e.g.*, Matthew Goldstein, *Why Merrill Lynch Got Burned*, BUS. WK., Oct. 25, 2007.

35. *See, e.g., Merrill to Close Lender First Franklin*, USA TODAY, Mar. 5, 2008.

36. According to the report, Lehman temporarily moved $50 billion of assets off its books in the months before its collapse in September 2008. Michael J. de la Merced & Andrew Ross Sorkin, *Report Details How Lehman Hid Its Woes*, N.Y. TIMES, Mar. 11, 2010.

failure to properly oversee the institutions through its Consolidated Supervised Entity program, under which the leveraging of the major U.S. investment banks grew rapidly in the years before the crisis.[37]

As for AIG, its downfall largely resulted from its credit default swap business run principally out of the London office of one of its subsidiaries, AIG Financial Products. A portion of those swaps insured the performance of subprime-MBS, but all of the swaps benefited from AIG's own credit rating, which, due to the strength of its insurance company subsidiaries, had long been AAA. However, as a result of increased losses at AIG in 2008, and in the wake of the Lehman bankruptcy, Standard & Poor's and Moody's downgraded AIG on September 16, 2008. The downgrade required the posting of an additional $14.5 billion in collateral to AIG's credit default swap counterparties, which in turn drove down AIG's share price and threatened its existence as a going concern.[38]

The events of September 13 to 16 were instrumental in shaping the debate over many of the most important provisions of the Dodd-Frank Act. The perceived undercapitalization and overleverage of Lehman and Merrill, and the interconnectedness of AIG, gave rise to the desire for a supervisor for systemically significant financial institutions, which led ultimately to the creation of the Financial Services Oversight Council in Title I of the Dodd-Frank Act.[39] The perceived inability of the regulators to take control of Lehman and AIG outside of a bankruptcy gave rise to the desire for an alternative resolution mechanism for systemic firms, as an alternative to a Bankruptcy Code liquidation; this ultimately led to the creation of an "Orderly Resolution Authority" in Title II of the Dodd-Frank Act.[40] The perception of favoritism—that Lehman was "allowed" to fail, while AIG was rescued by the Federal Reserve under its emergency section 13(3) powers—led to calls for reforming the Federal Reserve's emergency lending powers and to restrictions on those powers in Title XI of the Dodd-Frank Act.[41] Finally, because AIG owned a federal thrift and was regulated by the OTS as a thrift holding company, its collapse was yet another example marshaled by critics of the OTS in calling for that agency's demise.[42]

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37. *See, e.g., Public Policy Issues Raised by the Report of the Lehman Bankruptcy Examiner: Hearing Before the H. Comm. on Financial Services*, 111th Cong. (Apr. 20, 2010) (statement by Anton R. Valukas).
38. *U.S. to Take Over AIG in $85 Billion Bailout*, WALL ST. J., Sept. 16, 2008.
39. For a more detailed discussion of Title I, see *infra* chapter 4.
40. For a more detailed discussion of Title II, see *infra* chapter 5.
41. For a more detailed discussion, see *infra* chapter 7.
42. *American International Group: Examining What Went Wrong, Government Intervention, and Implications for Further Regulation: Hearing Before the S. Comm. on Banking*, 110th Cong. (Mar. 5, 2009).

§ 2:3.5 Too Big to Fail II: Citigroup and Bank of America

After the Lehman, Merrill, and AIG events unfolded, the U.S. Congress, at the urging of the Bush Administration, entered the fray, passing the EESA, which created TARP on October 3, 2008. TARP rapidly became synonymous with "Bailout," and it was vilified by many on both sides of the political aisle. It is, however, hard to argue that TARP has not had its successes, at least as far as major institutions are concerned.

In the late fall of 2008, however, it was not at all clear that TARP—which is described in more detail in chapter 3 below—would be successful, as two of the nation's leading financial institutions, Citigroup and Bank of America, required additional assistance from the U.S. Treasury. The first of these institutions to run into new troubles was Citigroup. Like Lehman and Merrill, Citigroup had substantial exposure to the housing sector through large holdings of mortgage-related securities, and its share price had been battered throughout 2008, a year in which it lost approximately $27.7 billion.[43] As a result, Citigroup was one of the institutions that received the maximum amount of original TARP funds, $25 billion on October 28, 2008.[44]

As with many of the failed institutions described in this chapter, the crisis at Citigroup began with a precipitous decline in its share price, which fell from around $13.99 at the market's close on November 3, 2008 to $3.05 on November 21, 2008, before rallying to $3.77 at the close of that day. As in the case of Lehman, Citigroup's counterparties began to lose confidence in the institution—from November 17, 2008 to November 21, 2008, Citigroup's credit default swap spreads more than doubled. Over the night of November 20 to 21, 2008, Citigroup's balance of available funds in its Global Transaction Services unit shrank by $13.8 billion, from $288 billion to $274.2 billion.[45] In addition, regulators perceived that Citigroup was having difficulties obtaining short-term funding from other traditional means.[46]

The weekend of November 21 to 23 proved to be another extraordinary step in the pattern of government assistance—in this case, including "open bank assistance" by the FDIC. Because the assistance to be provided by the FDIC would not satisfy the statutory requirement that it would be the "least costly" means of resolving Citibank, the Secretary of the Treasury was required to make a written determination,

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43. *Citigroup*, N.Y. TIMES, July 15, 2011.
44. Off. of the Special Inspector Gen. for the TARP, Extraordinary Financial Assistance Provided to Citigroup, Inc. (Jan. 13, 2011).
45. *Id.*
46. *Id.*

on the prior recommendations of the Board of Directors of the FDIC and the Federal Reserve, and in consultation with the President, that failing to act would create "systemic risk." This determination was made by Secretary Paulson on November 23. In the meantime, Citigroup, at the urging of the Federal Reserve Bank of New York, had made a proposal for additional government assistance.

Citigroup's proposal was based on a plan developed in connection with its unsuccessful attempt to purchase Wachovia Corp. in October 2008, which too was premised on open bank assistance. The proposal, which was made on November 22, was not for a second capital injection. Rather, it sought a U.S. government guarantee of 100% of the total value ($306 billion) of a pool of troubled assets that were causing Citigroup's investors and counterparties the most concern, in return for the U.S. government being issued $20 billion in preferred shares with a 5% dividend, redeemable at Citigroup's option in five years in cash or common stock.[47] The following day, Sunday, after the Systemic Risk Determination had been made, the government issued its counterproposal: an asset pool guarantee of the same size, but Citigroup was to accept the first loss position in an amount of $37 billion, with losses in excess of that amount to be shared by the government (90%) and Citigroup (10%). The government was to receive a premium of $7 billion in preferred shares paying an 8% dividend, and would make a capital infusion of $20 billion, in the form of preferred stock with an 8% dividend.[48]

Citigroup accepted the government's proposal, and its share price decline stabilized, at least temporarily. In the spring of 2009, however, that price declined again, to less than $1 per share, and the government announced that it would convert certain of its preferred holdings to common stock and certain to trust preferred securities in order to bolster Citigroup's capital ratios.[49] The conversion procedure resulted in the government owning 33.6% of Citigroup's common stock in July 2009.[50]

The Citigroup example was followed in January 2009, when significant escalating losses at Merrill raised questions over whether Bank of America would complete its acquisition of the investment firm or rather claim that a "Material Adverse Effect" under its Merger Agreement had occurred. After discussions with the government, Bank of America completed the deal by year-end. Less than three weeks

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47. *Id.*
48. *Id.*
49. *Id.*
50. *Id.*

later, Bank of America received a $20 billion capital injection in the form of preferred stock paying an 8% dividend.[51] In addition, a term sheet for a similar "loss sharing" arrangement over a pool of $118 billion in assets was negotiated, but a final agreement was not completed.[52]

51. Off. of the Special Inspector Gen. for the TARP, Emerging Capital Injections provided to Support the Viability of Bank of America, Other Major Banks, and the U.S. Financial System (Oct. 5, 2009).
52. *Id.*