

**The Subprime Crisis and  
its International Consequences**  
What Happened and How to Avoid Similar Crises?  
Paris, April 4, 2008

**Panel 2: Practitioner Presentation**

An inconvenient truth is that, in a market system, financial markets are cyclical in nature and prone to instability. Instability can be caused by a single event - - called a “financial accident”- - like the failure of a major player (like LTCM or, say, Bear Stearns) or an outside exogenous event (like the Asian currency crisis in 1997 or the Russian debt default in 1998). It can also be caused by unsound lending practices in an entire market or financial speculation (like the collapse of the Internet bubble). The current crisis, bought on by unsound mortgage lending, fits into the latter category.

There are specific policy prescriptions for containing and ameliorating a credit crisis, although it must be said that each crisis is different – if not unique – and requires an individualized response. Unfortunately, there is no formula or “magic bullet” which applies to every crisis, although there are common features of generalized credit crises which lend themselves to common understanding, as well as specified policy actions.

Obviously, the distinguished members of the panel have addressed policy actions relating to the current crisis and what should be done in the future to make credit markets more

secure. This will involve specific actions by the monetary and other governmental authorities, as well as remedial action by major market participants. As to the future, there are a series of regulatory actions which would probably make sense and make credit markets and the financial system less prone to accidents and crises.

I want to address a few remarks to the role of the U.S. legal system in dealing with the mortgage lending and financing crisis from a policy perspective.

### **Policy Roles of Law Enforcement**

(1) Much of what we have heard today - - both as to the cause and remedies for the mortgage lending crisis and how to deal with generalized credit crises now and in the future - - raises public policy issues best addressed by legislation, increased government regulation, additional self-regulation by industry actors and self-help by market participants. However, legal enforcement of existing and possibly new laws can play an important role in containing and remedying the current crisis from a policy perspective. Law enforcement actions halt ongoing wrongdoing, punish past wrongdoing, provide relief for victims and deter future bad acts. Law enforcement also serves as a basis for existing regulation and new legislation. These considerations are particularly important in dealing with the mortgage lending and financing abuses that were at the center of events which have expanded into the current credit crisis. Currently, there are numerous federal and state investigations which will provide important factual details underlying industry practices that may need to be addressed prophylactically.

(2) Obviously, law enforcement will not likely have significant effects on the

immediate credit crisis (which has to be dealt with by aggressive action by the economic authorities). More likely it will have more longer term effects by assessing responsibility for the excesses of the current credit cycle and egregious behavior which contributed to the credit crisis. Under U.S. law, legal enforcement will permit a determination of whether unsound mortgage lending and financing practices were the unforeseeable consequences of normal market forces or legally sanctionable. Such a determination in specific factual contexts will permit more effective government regulation and/or more legislation.

(3) In the U.S., there is a two tier system of law enforcement consisting of governmental (public) legal enforcement and private legal enforcement. Several major legal statutes that apply to mortgage lending and financing - - such as federal and state securities laws - - provide for dual enforcement. Governmental law enforcement takes place at the regulatory level (i.e., within governmental agencies) and in the judicial system. Private enforcement takes place exclusively in the judicial system in the civil justice system.

### **Governmental Legal Enforcement**

\_\_\_\_\_(4) The U.S. maintains a federal system consisting of the national (federal) government and state governments. Both federal and state authorities have law enforcement responsibilities concerning mortgage lending and financing.

#### **a. Federal Regulatory Oversight and Law Enforcement**

i. There is federal agency oversight in the federal banking agencies including the Treasury Department (Office of Comptroller of the Currency); the Federal Reserve

System; the Federal Deposit Insurance Agency (FDIC); Office of Thrift Supervision (OTS); and the National Credit Union Administration (NCUA).

ii. There are additional federal agencies which also have jurisdiction including the Federal Trade Commission (FTC); Housing and Urban Development (HUD); the U.S. Securities and Exchange Commission (SEC) and the U.S. Department of Justice (DOJ).

iii. Together, these agencies enforce federal banking, securities and consumer protection laws. Presently, the DOJ and the SEC are conducting a number of criminal and civil investigations into mortgage lending and financing.

**b. State Regulatory Oversight and Law Enforcement**

i. The states also maintain agencies which are responsible for applying banking, mortgage lending regulations, and consumer protection.

ii. The states can also enforce common law prohibitions on public nuisances and negligent, reckless or intentional misconduct.

iii. State law enforcement is lodged in the State Attorney Generals and in State regulatory agencies. The State Attorney General also has multiple ongoing investigations.

(5) There has been a recent trend away from dual federal and state governmental law enforcement in favor of federal laws and regulations preempting state law and regulations. The policy rationale for federal preemption is to achieve more uniformity in legal duties imposed on industry and to eliminate over-regulation. However, while policies of uniformity and less regulation have merit, recent experiences in mortgage lending and financing

shows that the dual system of government law enforcement is necessary to maintain adequate regulation and control of regulated conduct in these industries. Unlike in Europe, where national government agencies have a greater degree of independence from the executive branch of the national government, in the U.S. power is centralized in the U.S. President as head of the executive branch. The President can impose a policy determination on the entire national government. Current and certain prior administrations have implemented a “hands off” philosophy of government regulation of business which itself has contributed to the current mortgage lending and financing crisis.

(6) From a policy perspective, under the U.S. federal system, state governments should retain the power to legislate, regulate and adjudicate the same conduct and market participants in the mortgage field over which the federal government has jurisdiction. Whatever the risks of non-uniformity or over-regulation, as shown by the current mortgage crisis and its dangerous extension to credit markets and, then, to the general economy, it is better to err on the side of caution and regulation.

### **Private Enforcement and the U.S. Civil Justice System**

(7) In addition to government law enforcement in the U.S. by federal and state authorities, the U.S. has a dynamic system of civil justice which permits private parties to sue for compensation and injunctive relief. Many securities and consumer protection statutes at both the federal and state levels, as well as common law rights, permit private suits and private enforcement of statutes and regulations. Private litigation is permitted in the U.S. only by

persons who have been injured by legally wrongful conduct. Traditionally, private litigation has served two principal policy purposes:

- a) compensation for economic harm actually incurred; and
- b) as a supplement to governmental legal enforcement.

The compensatory policy underlying the U.S. civil justice system is almost unique in the world. Currently, the U.S. civil justice system is the most sophisticated and comprehensive system of private legal compensation in the world. The civil justice system also serves as a supplement to enforcement of important federal and state policies, given the limited resources by enforcement authorities. The importance of private litigation from an enforcement perspective has been demonstrated over and over again in the securities law and antitrust areas.

(8) Recently, there has been a strong swing in sentiment in the U.S. away from civil remedies for injured persons by private suits in the civil justice system and private enforcement of federal and state law. The principal policy rationale for curtailed private civil litigation are avoidance of frivolous litigation, regulatory overkill and promotion of uniformity.

(9) A policy analysis of private civil litigation involves four considerations:

- a) A consideration of the validity of the principle of compensation for economic harm;
- b) The sufficiency of governmental enforcement efforts including reasonable compensation for economically injured parties. If the federal and state government pursued and obtained reasonable disgorgement of illegal gains by wrongdoers and made victims reasonably whole, there would be no need for private parties to sue at all. Such is not the case.

c) Adequacy of governmental enforcement efforts in policing proscribed conduct. Again, if government enforcement activity was extensive enough, there would be no need for private suits from an enforcement standpoint.

d) Control of abuses of the civil litigation system. Any policy analysis must recognize the existence of certain abuses in the civil litigation system. The principal abuse is the institution of non-meritorious litigation. Despite considerable agitation in the U.S. from business groups to the contrary, many steps have been taken to screen cases more carefully and reduce frivolous litigation:

- tightened pleading requirements relaxation of standards for summary disposition.

(10) A prime example are rules relating to the institution and prosecution of federal securities claims. The area of federal securities litigation has been tightened over and over again – perhaps overly so. But one major change in the institution of federal securities claims has been borne out from a policy standpoint and has received general support from both sides in the so called “tort reform” debate. In 1995, the U.S. Congress passed the PSLRA which shifted the control of securities class active suits to institutional investors who were regarded as more responsible than private individuals. The result is that, overall, the number of suits has declined since 1995 and recoveries have increased.

(11) From a policy perspective, the message is clear: Institutional investors have the ability, have used their ability and should use it in the future to help clean up the markets and get compensation for losses that have incurred.

### **The European Experience**

(12) While the U.S. has swung away from the dual enforcement system of public and private litigation, Europe is edging toward this system.

### **Summary**

(13) (a) Dual enforcement by governmental authorities and private parties is appropriate and beneficial from a policy perspective.

(b) In the U.S., governmental enforcement at both the federal and state level is both reasonable and necessary to protect the public interest. Indeed, there should be real effort to form a federal/state partnership to proceed in a more efficient and uniform fashion.

(c) elimination of litigation abuses by stronger litigation filters can improve private enforcement as a supplement to governmental law enforcement.

(d) Trends in Europe toward allowing private litigation should be encouraged, with strict limits on the abusive potential through strong screening methodologies.

(e) Institutional investors can and should take the lead in cleaning up the markets.