

A Comparative View of Underwriting, Deregulating, and Overturning in Banking

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ABSTRACT

During the 1980s, Congress passed a number of laws deregulating the US banking system and home loan process. Within a decade, this caused the demise of many savings and loans and has had major effects on banking into the twenty-first century. Several pieces of legislation have contributed to deregulation of the industry including Graham Leach Bliley and the Deregulation Monetary Control Act. In addition, more complex variable rate mortgages became permissible through the passage of AMPTA, which has added greatly to the number of defaults. Complexity in home loans followed under the so-called Truth in Lending Act and misled homeowners through nondisclosure of mortgage information. Although these laws were intended to save the banking industry, they had quite the opposite effect and have severely impacted the economy today. Through statistical analysis of the nation's mortgage debt, this paper shows that the current economic crisis is twice as bad as the Savings and Loan crisis. Analysis also shows the effect of lax lending and loan-originating policies in both periods.

INTRODUCTION

Since the beginning of our country's history, home ownership has been part of the American dream. Today, however, the simple goal owning a house and land requires a complex and elaborate process involving appraisals, realtor fees, closing costs, and most importantly, a mortgage. Sub-prime lending encouraged lower income families to believe they possessed a store of value. Instead of helping working class families to realize home ownership, however, Congress set the stage for a financial nightmare.

What is now materializing as a result of a softening real estate market is, in fact, a repetition on a much larger scale of the credit market mess that led to the stock market crash of 1987. Laws passed by Congress in the 1980s led to the deregulation of our banking system and this, combined with shoddy oversight, allowed banks to originate loans to just about anybody. With a lackluster regulation and insufficient legislation governing the banking industry, financial institutions were able to capitalize on those loans through the securitization process, which amounts to bundling and pooling the risk to be passed around. Today, however, the economy is much more interdependent and therefore our current crisis extends to other economic sectors as well as beyond our borders.

SAVINGS AND LOANS

In the aftermath of the Great Depression, institutions called savings and loans (S&Ls, also commonly referred to as thrifts) were established to stimulate the economy by accepting deposits and directing money to borrowers (homeowners). Indeed, S&Ls were designed to make home ownership a reality for average, middle-income families and even those with less-than-perfect credit. They were very different from commercial banks, whose function was to focus primarily on commercial and state loans that provided a much greater return (Glasberg & Skidmore, 1997).

S&Ls offered interest-earning accounts to depositors and made loans with higher rates of interest to offset the rates paid on deposit accounts. However, state legislation capped the interest rates that could be earned on such deposits to ensure S&Ls' commitment to providing affordable mortgages.

Deregulation of these limits, which will be discussed later in detail, abolished these state caps and is a major factor in one of the nation's worst financial crises in its history. Regulation Q, for instance, was passed by Congress primarily so that savings and loans and commercial banks would not compete with one another. The regulation allowed thrifts to offer a quarter percentage point more than the interest rate ceilings in order to attract more depositors (Glasberg & Skidmore, 1997). Commercial banks ultimately sought growth not through the margins achieved by lending of deposits, but by churning more and more loans, capturing the upfront fees and then selling off the loans to other institutions.

As a result of market caps on interest rates, investors began withdrawing their accounts to place them into investments with higher rates of return, especially money market funds. Once interest rates returned to higher levels, investors would redeposit their funds (*FDIC: The S&L Crisis: A Chrono-Bibliography*). The act of withdrawing funds, also known as disintermediation, made S&Ls extremely vulnerable and incapable of competing with more lucrative investments and led to deregulation of the industry.

Unlike commercial banks, thrifts were regulated by the Federal Home Loan Bank Board (FHLBB) and governed under an entirely separate framework (*History of the Eighties Lessons for the Future*, 1997). Savings and loans were also federally insured by a governing body similar to the FDIC, known as the Federal Savings and Loan Insurance Corporation (FSLIC), which was placed under the authority of the FHLBB. "For commercial banks and mutual savings banks the chartering and insurance functions were kept separate, whereas for federally chartered S&Ls the two functions were housed within the same agency" (*History of the Eighties Lessons for the Future*, 1997). The FHLBB provided poor oversight of the industry, partly because of its small size and limited resources. The inadequately supervised industry allowed S&Ls to engage in riskier activities and report such illiquid investments as assets on their balance sheets. Normally, loans backed by deposits are considered assets. These riskier assets were leveraged and had little backing.

Some claim that the S&L crisis did not directly result from deregulation, but an ineffective regulatory environment. However, both the government and the FHLBB should have known very well that the industry would run amok after such deregulation and without a watchful eye. S&L income totaled nearly \$800 million in 1980; in 1981, net losses for the industry were close to negative \$5 billion (*History of the Eighties Lessons for the Future*, 1997). By 1988, over 560 thrifts had failed and have since cost the country upwards of \$160 billion (*History of the Eighties Lessons for the Future*, 1997).

LEGISLATION AND DEREGULATION

The Banking Act (Glass-Steagall) of 1933 was passed during the Great Depression to restore consumer confidence in the banking system by establishing the Federal Deposit Insurance Corporation (FDIC), Federal Savings and Loan Insurance Corporation (FSLIC), and to distinguish commercial from investment banking. More specifically, it was meant to forbid the underwriting of stocks by commercial banks and reduce the risks of commercial banking (Cooper & Fraser, 1984). Until its partial rescindment (1982), then complete repeal (1999), Glass-Steagall prohibited banks and thrifts from underwriting corporate debt, equity, and other securities (Mester, 1996). The act essentially barred commercial banks and thrifts from doing any sort of business on Wall Street. To some, its repeal did nothing to support the very reason for thrifts – to make homeownership a viable option for all Americans.

The Gramm-Leach Bliley Act, which repealed Glass-Steagall, eliminated the need for intermediaries in underwriting securities. The act of simultaneously writing loans and underwriting securities, also known as concurrent lending, permits the transfer of risk. Such transfer, in turn, decreases the incentives of lenders to evaluate carefully borrowers' creditworthiness or ability to repay the loans. As a part of the lending process, banks usually collect both "hard" information – which provides a raw credit score of the borrower – and "soft," explains relationships with lenders, lists appraisers who valued the home, and offers years of documentation (Bennett, 2001). The quality and quantity of information collected and passed on through the securitization process, however, depends on the amount of risk assumed by the lender. In other words, banks are less likely to perform

extensive credit checks if they are not going to hold the loans and will not provide a full picture of the creditworthiness of securitized loans that might reduce their value.

"The market has seen an increase in the number of loans with reduced 'hard' information in the form of limited or no documentation; . . . a no documentation loan provides no information about income or assets" (Bennett, 2001). Several documentation classes of loans were offered with corresponding interest rates and spreads. In addition to "No Doc" loans, these included NINA (no income no assets), SISI (stated income stated assets), and "No Ratio." Some of these were geared toward self-employed professionals who did not have the documentation (tax returns) to support their 'stated income.'

During the 1980s, the American Bankers Association opposed Glass-Steagall, claiming that it prevented commercial banks and thrifts from being competitive by restricting them from engaging in more profitable activities. But the ABA and its supporters did not mention that a conflict of interest arises when commercial and investment banks combine. The obvious difference is that banks that underwrite their own securities are less likely to represent them truthfully in an effort to realize the highest gain (Mester, 1996). This may result in an A-grade investment on the surface, but a return that is junk.

Glass-Steagall was intended to help offset large losses by banks that made loans to Cuba. These, which had been expected to be paid off as the market value of sugar rose, became useless when the value of sugar declined (Bennett, 2001). So, Glass-Steagall increased liquidity in these institutions that were selling virtually worthless securities to the public. What happened leading into the Great Depression was repeated during the 1980s stock market crash and is occurring again today. Sub-prime mortgages were expected to be repaid as housing values increased. When the housing bubble burst, however, many homeowners defaulted and caused banks that bought these sub-prime mortgages to become illiquid.

While some contend that Glass-Steagall's repeal was necessary to preserve banking liquidity, there are issues of ethics and morality when passing on dead-end investments. The speculative nature of securities markets was argued by most policymakers of the 1980s to be much too risky for the "active involvement of banks, whose deposit liabilities served as the nation's medium of exchange, and whose check-clearing process served as the nation's clearing mechanism" (Cargill, 1988).

DIDMCA

As a response to Glass-Steagall, the Depository Institutions Deregulation and Monetary Control Act (DIDMCA) of 1980 allowed S&Ls to compete with other institutions and investments. It increased competition with money market funds by removing interest rate caps and regulations on deposit accounts and allowed S&Ls to deviate from home loans and offer various sorts of loans for everything from corporate acquisitions to construction projects (Macey, 2006). DIDMCA was also meant to limit disintermediation by depositors who would place funds into investments with higher rates of return. In addition to ending interest rate limits, Congress raised federally insured deposit limits from \$40,000 to \$100,000 in an attempt to increase consumer confidence in the thrift industry. This measure was implemented to avoid runs on the banks, but was not followed by any further regulation to diminish risk posed by moral hazard (Macey, 2006).

The risk of moral hazard also grew as capital requirements of thrifts were reduced under the law. The previous net worth requirement of 5 percent on all insured accounts was now replaced by a minimum 3 percent and up to 20 percent of assets could be invested in consumer loans: credit cards (*History of the Eighties: Lessons for the Future*, 1997).

AMTPA

The legislation that severely impaired many sub-prime borrowers' ability to repay their mortgages and set the stage for countless defaults was the Alternative Mortgage Transactions Parity Act (AMTPA). With the passage of AMTPA in 1982, the fixed mortgage rate became a thing of the past, replaced by more "exotic" adjustable rate and variable payment mortgages (Christie, 2007). Such adjustable rate mortgages (ARM) have interest rates that vary with movement of an index, which is predetermined by

the borrower and credit union or other lender (Lobell & Freeman, 1983). AMTPA permitted interest rates to be adjusted according to supply and demand based on these indices. Rates of this nature are originally indexed to average six-month T-bills, the average yield of Treasury securities, or the FLHBB's average mortgage rate (Lobell & Freeman, 1983).

Unlike fixed rates, variable rates were used to minimize interest-rate risk for the banks by locking in the spread. The borrower would assume the risk of a rising interest rate. Often, banks took advantage of the consumer with these complex loans. The National Credit Union Administration believed "it unnecessary to regulate in this area . . . [and instead intended to] monitor . . . through examination and consumer complaint programs" (Lobell & Freeman, 1983). Indeed, no subsequent regulation was implemented to limit exploitation of homeowners.

AMTPA was designed primarily to allow all state-chartered depository institutions that did not have permission of state governance to create alternative mortgages as federally-chartered institutions that already held the right to distribute such loans (Stein 2000). This legislation, found under Title VII of the Garn-St. Germain Act, became a federal law. Consequently, the line of authority was blurred as state-chartered thrifts were able to operate under federal law, but state authority. Thus, institutions could choose whether to follow state or federal guidelines related to alternative mortgage transactions, which led, of course, to enforcement and borrower protection conflict (Stein & Pearce, 2000).

Some of the variable-type mortgages permitted under AMTPA include balloon, interest-only, and option-adjustable rate mortgages (Christie, 2007). The last of the three, which *Business Week* refers to as perhaps the "riskiest and [most] complicated home loan product ever created," initially offers artificially low interest rates and payments that a homeowner may defer for a number of years. The catch to the option-ARM is that unpaid interest during the first few years becomes part of the principal (accrued interest). Balloon-type mortgages are fixed rate; they are also short-term loans that have lower upfront interest rates and payments. The ballooning occurs when, for example, within the loan's eight-year maturity, the entire remaining balance comes due in one hefty lump-sum, to be refinanced at then market interest rates (*Balloon Mortgages*). The market for these loans consisted of consumers looking for shorter term commitments. The banks made money with upfront fees, points, and pre-payment penalties.

Fixed-rate borrowers, thanks to predetermined interest rates, are less disposed to what one source describes as "payment shock." Hybrid adjustable rate mortgage borrowers, who are a bit more stretched financially, are at higher risk of such shock. However, Standard & Poors refers to option-adjustable rate mortgage borrowers as most at risk for shock when the cost of borrowing rises (Rozens, 2008). Many of them bought "investment properties" with the leverage afforded by these loans. If real estate values continued to rise, after five years the returns looked very good. Other borrowers simply purchased properties that they could not originally qualify to afford.

The ability of most homeowners to refinance these adjustable rate mortgages severely diminishes as home values decline. The result is a thinner, if any, line of home equity. To top this off, a majority of sub-prime borrowers have "piggyback" mortgages, which means taking out a second loan to cover the (usually) 20 percent down payment. As a result, the ability to refinance is further diminished and default is imminent.

TRUTH in LENDING ACT and PREDATORY LENDING

Such complex and complicated loans are unlikely to be understood by the average homeowner or a sub-prime borrower whose education is unlikely to have gone beyond secondary school. These complex financial products, under the Truth in Lending Act (TILA), required proper and accurate disclosure to the borrower. Proper disclosure was meant to protect the consumer from unscrupulous or greedy lenders. Disclosure of the amount financed, the annual percentage rate, the variable rate, and payment schedule are among the many features to be divulged (*Department of Real Estate: California*). Despite TILA's existence, the disclosure to borrowers is, in fact, very perplexing and thus may be misleading.

Regulation Z of TILA, which establishes disclosure guidelines for mortgages, has a very extensive scope including the various and elaborate types of ARMs. The vast range of mortgage

instruments available to consumers makes Regulation Z disclosure requirements difficult to standardize: “[ARMs] involve large sums and long maturities, which tend to magnify the impact of errors” (Barefoot, 1991). The American Banker’s Association (ABA) notes improper disclosure of introductory discount or “teaser” rates as one of the most common abuses by banks. These artificially low introductory rates can be misleading; lenders may not reveal that they do not apply for the whole loan term and will be reset after two or three years, causing payments to increase and rates to jump to over ten percent (Christie, 2007). As a result, borrowers are duped into thinking they can afford the payments associated with a mortgage. However, once rates are readjusted, the sub-prime homeowner frequently suffers from “payment shock.” The second most common problem reported by the ABA is failure of banks to adjust rates of ARMs correctly.

Broker incentives and predatory lending are also relevant matters since brokers are the ones providing loans and advising consumers. The type of loan the broker or loan officer recommends is usually not contingent upon the buyer’s needs, but the commission paid to the broker. In a (normally) commission-based environment the broker will suggest a mortgage that offers the greatest return to him or her! A major source of a mortgage broker’s commission income is the yield spread. This is the return (percent of loan amount) offered by the banks to the broker for placing loans at particular interest rates – higher interest rates paying more. Some states put limits on the amount of yield spread that a broker can earn.

The ABA notes that women, the elderly, and minorities are among the leading demographic groups targeted by predatory lenders. Specific data on predatory lending, however, are largely unavailable from any of the regulatory bodies because there are “no ready way[s] to identify predatory loans or measure the amounts involved” (Peterson, 2001). Despite the lack of hard proof, the Federal Reserve, FDIC, Office of the Comptroller of Currency, and Office of Thrift Supervision all warn that predatory lending exists and is a problem.

Banks holding such loans are more likely to exercise caution in determining creditworthiness. However, since most institutions do not hold onto them, this is not a major issue in the lending process. As a result, originators may not even assess credit and may approve loans with no documentation – loans then securitized and sold on Wall Street.

INVESTMENT and COMMERCIAL BANKING

By the early nineteen-nineties, the Resolution Trust Corporation had cleaned up the savings and loan industry; it was replaced by an industry defined by a combination of commercial and investment banking. But the structure of the banking industry and its regulatory framework remained chiefly as it was. As we entered into a new era of banking defined by advances in technology and sophisticated investments, one would hope that the regulatory structure would be adjusted accordingly. Yale economist Robert Shiller uses the analogy of a train when describing our current economic debacle; a powerful train is only as good as the track on which it travels (Schiller, 2008).

Until 1999, investment and commercial banking could not be practiced under the same roof. The Financial Services Modernization Act ended this separation and gave birth to what the *Wall Street Journal* calls “financial supermarkets” (Enrich & Paletta, 2008). These institutions could provide checking and savings accounts in addition to offering a wide array of financial products and services. More specifically, the FSMA reintroduced mortgage-backed securities into a market in which companies were able to originate loans, bundle them up, and ship them off to Wall Street.

Lehman Brothers Holdings, Morgan Stanley, and Goldman Sachs were among the last US investment banks standing by 2008. Investment, and even commercial banks with exposure to the sub-prime market realized a significant loss in liquidity. Wachovia, a commercial bank, lost nearly \$7 billion from adjustable rate mortgage defaults (Bogoslaw, 2008). Loan originators and those who securitized the loans, however, are far from the only ones affected.

JPMorgan invested in many corporate and government loans, and to hedge itself from interest rate and commodity fluctuations, it also invested in credit default swaps (Philips, 2008). These instruments used to encourage investors to engage in risky ventures, in hopes of higher returns and greater profits. “Everyone and their dog decided to jump in,” explains Rohan Douglas, who formerly

worked on credit default swaps for Salomon Brothers and Citigroup. Companies such as AIG entered the hot market and started offering insurance, similar to what one would have for one's home, except it covered defaults. As the real estate market plummeted and homeowners began defaulting, companies such as AIG had to act on those insured defaults, leading to an ugly bankruptcy and an even uglier bailout. Moreover, government sponsored agencies, Fannie Mae and Freddie Mac, required aid as the two quietly went under.

Despite policymakers' belief that American investment banks and the American economy were too big to fail, they ultimately did. Just as DIDMCA raised insured deposits in the 1980s, Congress raised deposit insurance to \$250,000 to increase consumer confidence in the banking industry and avoid runs on banks. One of the differences between the current banking crisis and its S&L predecessor is that financial instruments have become vastly more complex and unpredictable (Prins, 2008). This may stem from the various adjustable rate mortgages made available under AMTPA and their fluctuating repayment patterns and interest rates. But whatever the cause, financial market and asset-backed securities predictability models proved insufficient in the US and worldwide.

STATISTICAL ANALYSIS

To say the S&L storm of the eighties and the current financial crisis are similar is a fair statement, but to pronounce them identical is erroneous. One may compare them through an analysis of the Dow Jones Industrial Average (DJIA), a seemingly reasonable and unbiased indicator of economic conditions, for the years 1984-1987 and 2005-2008. Nineteen-eighty-seven is significant for "Black Monday," one of the lowest one-day drops in stock market history. Two-thousand-eight saw the market plummet back to 2003 levels.

From 1984-1987, the Dow Jones Industrial Average experienced unprecedented annual growth, even in the year of the crash (See Exhibit 1).

Exhibit 1

	Dow Jones Industrial Average	% Change
1984	1207.38	-
1985	1374.31	13.826%
1986	1877.71	36.629%
1987	1993.53	6.168%
2005	10440.07	-
2006	12080.73	15.715%
2007	13930.01	15.308%
2008	9336.93	-32.973%

Source: Commodity Systems, Inc.

By contrast, from 2005-2007 change remained fairly flat while 2008 recorded a drop of almost 40%! The latter also reflects the likelihood of homeowners' repayment of debt. Since the return on stock market investments was negative from 2005-2008, the market was not a source of income for homeowners. Thus, those on limited incomes and retirees struggled to find additional sources for mortgage repayment. While both eras differ in severity, they are certainly similar in pattern (See Exhibit 2).

Exhibit 2



J. BARR: A COMPARATIVE VIEW OF DEREGULATION IN BANKING

Another mechanism for comparison is outstanding mortgage debt as a percentage of gross domestic product. The data sets need not be adjusted into real terms since they become comparable once converted into a percentage. The object of the hypothesis is to prove that both periods were not the same; indeed, that the latter was much worse. Here, the null hypothesis is that the mean difference between the percentage of mortgage debt over GDP between the periods 1984–1987 and 2005–2008 is equal to zero. The alternative hypothesis is that the mean difference between the two percentages from those periods is different, or not equal to zero. Below is a summary of the hypotheses:

Ho: $\mu = 0$

Ha: $\mu \neq 0$

When a t-test is conducted at an alpha level reasonably at .05, the test statistic generated is 11.96 and the critical value of the two-tailed test is 3.18 (See Exhibit 3).

Exhibit 3

	Outstanding Mortgage Debt	GDP (Billions)	% of GDP
1983	1,210.6	3,690.40	32.80403%
1984	1,351.4	4,036.30	33.48116%
1985	1,529.9	4,321.80	35.39960%
1986	1,732.6	4,546.10	38.11179%
2007	11,027.9	14,031.20	78.59556%
2006	10,421.4	13,370.10	77.94557%
2005	9,344.8	12,696.40	73.60197%
2004	8,284.2	11,948.50	69.33255%

t-Test: Paired Two Sample for Means

	<i>Variable 1</i>	<i>Variable 2</i>
Mean	0.349491452	0.748689104
Variance	0.000565391	0.001853671
Observations	4	4
Pearson Correlation	-0.996045046	
Hypothesized Mean Difference	0	
df	3	
t Stat	-11.95710748	
P(T<=t) one-tail	0.00062912	
t Critical one-tail	2.353363435	
P(T<=t) two-tail	0.001258241	
t Critical two-tail	3.182446305	

Source: Board of Governors of the Federal Reserve System

Since the test statistic is greater than the critical value, one is able to reject the null hypothesis and accept the alternative. Thus, it is safe to say that the mean difference between the two periods' outstanding mortgage debt to GDP ratio is not equal to zero and the means are in fact different.

To take the analysis one step further, assume that the outstanding mortgage debt during the years of 1984–1987 was doubled. With the same set of hypotheses and again at an alpha level of .05, the

results are a bit different from before. Here, the test statistic is approximately 1.10 and the critical value, 3.18 (See Exhibit 4).

Exhibit 4

	Outstanding Mortgage Debt	GDP (Billions)	% of GDP
1983	2,421.2	3,690.40	65.60806%
1984	2,702.8	4,036.30	66.96232%
1985	3,059.8	4,321.80	70.79920%
1986	3,465.2	4,546.10	76.22358%
2007	11,027.9	14,031.20	78.59556%
2006	10,421.4	13,370.10	77.94557%
2005	9,344.8	12,696.40	73.60197%
2004	8,284.2	11,948.50	69.33255%

t-Test: Paired Two Sample for Means

	<i>Variable 1</i>	<i>Variable 2</i>
Mean	0.698982904	0.748689104
Variance	0.002261562	0.001853671
Observations	4	4
Pearson Correlation	-0.996045046	
Hypothesized Mean Difference	0	
df	3	
t Stat	-1.098227783	
P(T<=t) one-tail	0.176172665	
t Critical one-tail	2.353363435	
P(T<=t) two-tail	0.35234533	
t Critical two-tail	3.182446305	

Source: Board of Governors of the Federal Reserve System

Since the test statistic does not exceed the critical value, the null hypothesis is accepted. Consequently, one can gather that the period 2005–2008 was nearly twice as bad as the period 1984–1987 and had relatively twice as much outstanding mortgage debt.

This indicates that there has been an overall credit policy change since 1987, embodied in the deregulated mortgage environment and lax lending policies. By allowing an increasing number of mortgages to be originated, with higher values, less documentation, and even less regulation, the country’s outstanding debt had doubled in just two decades. The data show that America has lightly and carelessly taken on debt in the housing sector, and this extends unquestionably to other types of debt as well.

CONCLUSION

At its current rate, outstanding debt will inevitably exceed gross domestic product. Without restructuring of regulatory bodies and an overall change in American credit policy, these debts will continue to plague Wall Street and undermine the free market to which Congress continues to provide relief. Using the S&L crisis for comparison, the current situation is unraveling on a much grander scale and ultimately will require more than a Resolution Trust Corporation equivalent or another “bail-out.”

Indeed, it will require entirely new infrastructure for the banking industry *and* the asset-backed securities market in order to restore confidence in the economy.

Banking regulation must be flexible and capable of amendment as needed in this constantly changing economic environment. Evidence of this need can be traced back to AMTPA; insufficiently regulated state-chartered banks were allowed by federal regulation to issue variable-rate mortgages. At the very heart of it, there must be a cautious availability of overall credit, not only in the housing sector. Similarities between the two financial crises give evidence that history does in fact repeat itself. Only with ample reform and restructuring of its tracks will Shiller's train move forward.

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