LISTENING TO CASSANDRA: THE DIFFICULTY OF RECOGNIZING RISKS AND TAKING ACTION

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A breach was made in the walls [of Troy]; wheels were placed under the [wooden] horse; hempen ropes were fastened to its neck. And thus the deadly contrivance entered the sacred bounds of Troy, while youths and maidens tugged at the ropes, sang hymns, and stroked the horse joyfully with their hands. Four attempts had to be made to drag it through the opening, and each time, as it stuck, a sound of arms [from the warriors hidden within] came out of its belly. But the Trojans, befuddled and robbed of their wits, ignored everything, not stopping until the monster took its position in their sacred acropolis.

Then Cassandra came forth and prophesied what was to come. No one paid the slightest heed.¹

In Greek mythology, Cassandra had the gift of prophesy. She was able to accurately articulate dangers ahead. On numerous occasions she warned of impending catastrophe. Before anyone else was aware of the danger, for example, she tried to warn the people of Troy of the danger posed by the army hidden in the wooden horse given to the city. But, no one listened. As a result of Apollo’s curse, Cassandra is condemned to endlessly warn people who do not heed her warnings.

Something similar to Cassandra’s frustration is experienced in different settings when people who have identified an unrecognized danger try to warn others of the need to take corrective action. When a law firm’s client or one of the other parties involved in a transaction insists on opinion letter language which a partner views as overly optimistic, for example, that risk-averse partner may find himself in Cassandra’s situation if he fails to persuade other partners on the opinion committee at his firm not to include the problematic language in the opinion rendered. Furthermore, even a lawyer who intends to objectively analyze potential risks may remain

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¹. RICHMOND Y. HATHORN, GREEK MYTHOLOGY 375 (1977).
unaware of the operation of cognitive biases, which may indeed be influencing his analysis.

On a macroeconomic level, with effects that have reverberated throughout our economy, many have tried to ameliorate some of the unrecognized systemic risks that eventually led to the freezing of the credit markets and cascade of problems collectively referred to as the financial crisis of 2008–2009. The inability of decision makers to heed those warnings merits further examination.

I. OVERVIEW

The developments of the past two years have focused national attention on the operation of our financial markets. There are a number of interrelated factors that have contributed to our collective inability to appreciate the extent of the risks to which investors, lenders, homeowners, and taxpayers were exposed. More factors will undoubtedly become apparent as illiquid assets in lenders’ portfolios shift from being marked to model to being marked to market. Uncollectible loans will be restructured or resolved through debtors’ bankruptcies. Judges will determine how the obligations of lenders who did not record their interest in their parcel of real estate with the county recorder’s office should be prioritized. Presumably, courts will arrive at a consensus regarding whether to permit foreclosures when the entity seeking to foreclose is either an investor holding only one slice of a loan (rather than the entire obligation) or a nonlending servicing representative, such as Mortgage Electronic Registration Systems, Inc. (MERS), which is a nominee for the lender and its successors in interest but has no lending relationship with the borrower.

2. Relevant cognitive biases, including confirmation bias, overconfidence bias, bounded search, and status quo bias, which have been shown to effect deliberations in many contexts, are discussed, infra, in Part IV.C.1.

3. Systemic risk is generally defined as the risk that a disruption (at a single corporation or other entity, in a market segment, or to a trade settlement system, for example) could cause widespread difficulties at other firms, in other market segments, or in the financial system as a whole. See, e.g., Paul Kupiec & David Nickerson, Assessing Systemic Risk Exposure from Banks and GSEs Under Alternative Approaches to Capital Regulation, 28 J. REAL EST. FIN. & ECON. 123, 123 (2004) (“Systemic risk can be defined as the potential for a modest economic shock to induce substantial volatility in asset prices, significant reductions in corporate liquidity, potential bankruptcies and efficiency losses.”).

4. Marked to model refers to estimating the value of an asset based on a mathematical formula or judgment regarding the anticipated price the asset could hypothetically be sold for if an active market existed; marked to market refers to a value that reflects an actual price the asset actually would be sold for in an active market for the asset. See, e.g., Richard J. Herring, The Known, the Unknown and the Unknowable in Financial Policy: An Application to the Subprime Crisis, 26 YALE J. ON REG. 391, 395 (2009); see also David Jones & John Mingo, Industry Practices in Credit Risk Modeling and Internal Capital Allocations: Implications for a Models-Based Regulatory Capital Standard, ECON. POL’Y REV., Oct. 1998, at 53, 55–56; The Causes and Current State of the Financial Crisis: Hearing before the Financial Crisis Inquiry Commission, 111th Cong. 28 (Jan. 14, 2010) (statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corp.).

5. See, e.g., Saxon Mortgage Servs., Inc. v. Hillery, No. C-08-4357, 2008 WL 5170180, at *5 (N.D. Cal. Dec. 9, 2008) (“[F]or there to be a valid assignment, there must be
II. DEREGULATION IN THE RESIDENTIAL MORTGAGE CREDIT MARKET

Beginning in the 1980s, a series of statutes significantly changed the landscape in the residential mortgage credit market. Responding to inflationary pressures, Congress enacted the Depository Institutions Deregulation and Monetary Control Act of 1980, which repealed usury caps on first-lien residential mortgages.

Congress also granted lenders a greater degree of freedom when it permitted adjustable rate mortgages, balloon repayment clauses, and negative amortization loans in the Alternative Mortgage Transaction Parity Act of 1982. In the Home Ownership and Equity Protection Act of 1994 (HOEPA), Congress gave the Board of Governors of the Federal Reserve (the Federal Reserve Board) the authority under the unfair and deceptive acts and practices provision of the statute to issue regulations addressing lax underwriting and deceptive sales practices that hurt consumers.

In the Gramm-Leach-Bliley Act, Congress relaxed regulatory requirements to permit a new creature, a bank holding company, which is allowed to own full-service investment banks and insurance underwriters as well as banks. The Federal Reserve (the Fed) was given the responsibility of supervising these new entities and their significantly higher risks associated with the integration of these various services. But, in the same legislation, the Fed’s ability to perform adequate supervisory examinations of the financial holding companies was undercut in certain ways. The Fed’s examination of a nonbank subsidiary of the financial holding company is supposed to be limited to only the extent to which its operation “could have a materially adverse effect on the safety and soundness of a bank or thrift affiliate due to its size, condition or activities or the nature or size of its transactions with the bank or thrift.”

And, rather than conducting its own examinations, the statute specifies that more than just assignment of the deed alone; the note must also be assigned. MERS purportedly assigned both the deed of trust and the promissory note. However, there is no evidence of record that establishes that MERS either held the promissory note or was given the authority to assign the note. (citations omitted)); In re Vargas, 396 B.R. 511, 517 (Bankr. C.D. Cal. 2008) (“MERS presents no evidence as to who owns the note, or of any authorization to act on behalf of the present owner.”); Landmark Nat’l Bank v. Kesler, 216 P.3d 158, 166 (Kan. 2009).


13. McCoy et al., supra note 8, at 1345 n.41.
the Fed is supposed to rely on examination reports generated by state banking regulators and other federal regulators as much as possible.14

The Fed had the power under HOEPA to issue regulations that would curb lending practices by both banks and their nonbank lending affiliates that are “abusive or against the interest of the borrower.”15 Implementation of the powers granted in this statute to rein in abusive lending practices would have allowed the Fed to exercise a significant degree of oversight in both the initial purchase and refinance markets, potentially curtailing some of the problematic aspects of lending activity in those markets through the early years of this century. However, as Patricia McCoy recounts, “Federal Reserve Board chairman Alan Greenspan . . . declined to implement this provision” for years while abusive lending practices, including no-documentation loans (extended without regard to the borrower’s repayment ability), loan agreements providing for negative amortization (in which the regular periodic loan payments do not cover the full amount of interest due), and balloon payments at the end of short-term loans, increased.16 These and other problematic lending practices relating to faulty disclosures became increasingly frequent.17 Rather than having the Fed exercise the full available power of its enforcement authority, then-Chairman Alan Greenspan chose to issue only nonbinding statements and guidance.18 As Greenspan explained in his 2008 testimony before the House Committee on Oversight and Government Reform, the Fed staff was concerned that a difficult case-by-case process would be needed to determine precisely which lending practices and loan terms were unfair and deceptive.19 In addition, according to Greenspan’s testimony, since it would be difficult to determine which practices were unfair and deceptive in the “vast majority” of situations, there was no reason to enforce the Fed’s standard even with respect to the “10 percent or so [that are] self-evidently unfair and

14. 12 U.S.C. § 1844(c)(2)(D). Unless an investment bank or insurance underwriting subsidiary meets one of three statutory tests, the Fed is to rely on reports of examinations conducted by others, such as the Securities and Exchange Commission, state securities regulators, or state insurance regulators, rather than initiating an examination. Id. § 1844(e)(2)(B)–(E).

15. McCoy et al., supra note 8, at 1334 (citing 15 U.S.C. § 1639(l)(2)); see 15 U.S.C. § 1639(l)(2) (“The Board, by regulation or order, shall prohibit acts or practices in connection with—(A) mortgage loans that the Board finds to be unfair, deceptive, or designed to evade the provisions of this section; and (B) refinancing of mortgage loans that the Board finds to be associated with abusive lending practices, or that are otherwise not in the interest of the borrower.”).

16. Id.


18. See McCoy et al., supra note 8, at 1334.

19. Greenspan Testimony, supra note 17, at 89 (“Well, let’s take the issue of unfair and deceptive practices, which is a fundamental concept to the whole predatory lending issue. . . . [H]ow do [the staff of the Federal Reserve] determine as a regulatory group what is unfair and deceptive?”).
deceptive.” One might ask why there was no urgency to address the ten percent of situations that, even at the time, the Fed leadership and staff viewed as “self-evidently unfair and deceptive.”

Greenspan’s decision to rely on the nonbinding statements and guidance proved to be particularly problematic in light of the race to the bottom effect of the deregulated lending environment. The Fed’s reluctance to enact binding regulations had an effect throughout the financial services industry. The major lenders that treated the nonbinding guidance as optional experienced a significant increase in market share when compared with those lenders that chose to align their lending practices with the Fed’s nonbinding statements. Relaxing the regulatory environment can have deleterious effects on the collectability of the loans made in some segments of the market. As McCoy notes, “It was only after defaults on subprime and other risky loans ballooned into a full-blown crisis that Greenspan’s successor, Ben Bernanke, promulgated a binding rule banning specific loan abuses—and even then only for a limited group of loans—in July 2008.”

III. REGULATORY FAILURE IN THE SUBPRIME LENDING MARKET

A. The Fed’s Refusal To Examine Affiliated Entities

From the information that is currently available, it appears that the Fed’s decision to refrain from exercising effective oversight of financial services lenders in the subprime mortgage market and refusal to conduct a top-down review of the entire lending entity, including the underwriting standards applied in the subprime arm, is an instance of regulatory failure. For more than ten years through the expansion of no-documentation loans, reverse amortization loans, and other predatory elements of the subprime lending market during the early part of this century, the Fed adhered to the unanimous decision reached by the Federal Reserve Board and announced on January 12, 1998, that the Fed would not conduct consumer compliance

20. Id. In his colloquy with Representative John Tierney, Greenspan stated that “maybe [ten] percent or so [of mortgage refinancings] are self-evidently unfair and deceptive, but the vast majority would require a jury trial or other means to deal with it.” Id.


22. See, e.g., Gary Gorton, Bank Regulation When ‘Banks’ and ‘Banking’ Are Not the Same, 10 OXFORD REV. ECON. POL’Y 106 (1994); Luigi Guiso, Paola Sapienza & Luigi Zingales, The Cost of Banking Regulation 1 (European Univ. Inst., Working Paper No. ECO 2007/43, 2007), available at http://www.kellogg.northwestern.edu/faculty/sapienza/htm/costofregulation.pdf (studying the effects of bank regulation and the impact of deregulation across provinces in Italy). The authors concluded that “where entry was more restricted the cost of credit was higher and—contrary to expectations—access to credit lower. The only benefit of these restrictions was a lower proportion of bad loans. Liberalization brings a reduction in rate spreads and an increased access to credit at the cost of an increase in bad loans.” Id.

23. McCoy et al., supra note 8, at 1334–35 (citing Truth in Lending, 12 C.F.R. pt. 226 (2009)).
examinations of nonbank affiliates of bank holding companies.\textsuperscript{24} Consumer Affairs Letter 98-1 formalized the Federal Reserve Board’s longstanding policy in connection with examinations by announcing, “the Federal Reserve will (1) not routinely conduct consumer compliance examinations of nonbank subsidiaries of bank holding companies and (2) not investigate consumer complaints relating to these subsidiaries.”\textsuperscript{25} In addition, the letter stated the following: “[W]ith regard to complaint investigations, the action establishes a policy in an area where the Reserve Banks have exercised their own discretion in the past. All consumer complaints against such entities received by the Federal Reserve System will now be referred to the Federal Trade Commission and not be investigated by Reserve Banks.”\textsuperscript{26}

The issuance of this letter formally announcing the Federal Reserve System’s policies marked an important step. It is the regulatory equivalent of formally announcing that the speed limit will no longer be enforced on a certain stretch of highway. Once such an announcement is made, it would be difficult to sanction a lawyer who advises his client that the regulator has, in fact, announced that it will no longer be enforcing the law. Of course, the lawyer can urge compliance with prudential standards, reminding the client of the advantages of self-restricting his speed to no more than 55 m.p.h. even when there is no external constraint. If the client asks the lawyer if he will get a ticket if he zips along at 95 m.p.h., however, it is difficult to fault a lawyer for responding with an accurate answer. The Fed’s formal announcement, combined with the increasingly deregulated banking environment during the following decade, officially opened the door for unscrutinized lending practices in that sector of the lending market, which ultimately contributed to the 2008 crisis in the financial markets. It is important to note that on September 14, 2009, under the leadership of Greenspan’s successor Bernanke, Sandra Braunstein, the Director of the Division of Consumer and Community Affairs issued CA 09-8,\textsuperscript{27} which officially established a new policy of exercising the Fed’s authority to examine the lending practices of nonbank affiliates of bank holding companies.\textsuperscript{28}

Although it does not contain language that explicitly revokes the earlier nonexamination policy, the 2009 letter supersedes the policy set forth in the


\textsuperscript{25} Id.

\textsuperscript{26} Id. (formalizing the policy “not to investigate consumer complaints relating to these [nonbank] subsidiaries”).


\textsuperscript{28} Id. (articulating a policy that includes “conducting risk-focused consumer compliance supervision of, and the investigation of consumer complaints against, nonbank subsidiaries of bank holding companies (BHCs) and foreign banking organizations (FBOs) with activities covered by the consumer protection laws and regulations the Federal Reserve has the authority to enforce”).
In his testimony at a hearing before the House Committee on Oversight and Government Reform in October 2008, Greenspan acknowledged that subprime mortgage originations were “the original source” of the 2008 credit crisis. Greenspan also testified that when Governor Edward Gramlich approached Greenspan to convey Gramlich’s concerns about problems with predatory lending, Greenspan responded that he had doubts about whether the Fed’s imposition of additional regulations to curb the emerging abuses in the subprime lending market would be successful. Greenspan went on to testify that at the time of the conversation he thought that a subcommittee of the Board would look into the matter; when that subcommittee did not present any recommendations to the full board regarding the subprime lenders, he presumed that the subcommittee members had concluded that no action was needed. Both Representative Henry Waxman and Representative John Tierney pressed Greenspan to respond to their questions regarding the Fed’s failure to exercise the power which the Fed had been granted when HOEPA was enacted in 1994 to rein in abusive lending practices in the residential mortgage market. Although Greenspan did not explicitly state in his testimony at that hearing that the Fed’s failure to implement the powers it had been granted in HOEPA was a mistake, he did reaffirm views he had expressed in March 2008, saying that “those of us who have looked to the self-interest of lending institutions to protect shareholders’ equity (myself especially) are in a state of shocked disbelief” at the scope of the crisis which originated in the securitization of subprime mortgages. This degree of surprise implies at least a tacit admission that, in hindsight, a greater degree of external evaluation of lending practices would have been prudent.

B. Other Federal Agencies’ Response to the Regulatory Gap

The decision of the Federal Reserve Board to abandon examination of affiliated lending entities formally announced an explicit gap in the regulatory system to which lending activity is subject.

The Fed, the Office of Thrift Supervision, the FTC, and state banking regulators each have a role to play. In broad terms, in the late 1990s, the Fed had oversight authority over all bank holding companies and all state-chartered banks that were members of the Federal Reserve System; the Office of the Comptroller of the Currency was responsible for overseeing nationally chartered banks; and the Federal Deposit Insurance Corporation was responsible for overseeing state-chartered banks, which were not

29. Greenspan Testimony, supra note 17, at 87 (agreeing with Representative John Tierney’s characterization of the issue).
30. Id. at 35.
31. Id. at 37–38.
33. For additional details on the interaction between these agencies, see, for example, McCoy et al., supra note 8, at 1348–51.
members of the Federal Reserve System. The role of all bank regulators is to ensure that the banks they oversee are sound and practicing prudent risk management, including an evaluation of the risks undertaken by a bank in its lending activities. Bank regulators have the authority, among other things, to establish capital requirements and information reporting systems, conduct periodic examinations, and to take enforcement actions when necessary. The Fed has the additional objective of ensuring the overall stability of the U.S. financial system. However, with the Fed refraining from engaging in an active examination process for affiliated lending entities, other agencies were deprived of a valuable enforcement tool that could have been used proactively to accurately assess and ameliorate systemic risks posed by lenders whose business practices included signing borrowers to no-documentation loans, balloon clauses, onerous prepayment penalties, and other features of some subprime loans. Although the Fed did convene an interagency task force to examine the issue of predatory lending, there was no effective substitute for initiating examinations of nonbank affiliates’ underwriting standards and lending practices, particularly when no other agency was empowered to engage in such examinations.

1. FTC Protects Consumers, But Does Not Conduct Bank Examinations

The FTC’s mandate is to halt “unfair and deceptive” or otherwise abusive lending practices, and the agency is tasked with investigating and suing lenders that allegedly engage in such practices. To halt unlawful abusive lending practices throughout the late 1990s and early 2000s, the FTC sued Capital City Mortgage Corporation (CCM) in January 1998, alleging that it was engaging in deceptive and unfair practices against borrowers throughout the lending relationship. The FTC claimed that CCM had engaged in flipping (inducing borrowers to refinance an existing residential

36. “When the FTC was created in 1914, its purpose was to prevent unfair methods of competition in commerce as part of the battle to ‘bust the trusts.’ Over the years, Congress passed additional laws giving the agency greater authority to police anticompetitive practices. In 1938, Congress passed a broad prohibition against ‘unfair and deceptive acts or practices.’” Federal Trade Commission—About Us, http://www.ftc.gov/ftc/about.shtm (last visited Mar. 3, 2010).
37. Such practices violate section 5 of the FTC Act. See 15 U.S.C § 45 (2006); FTC Office of the General Counsel, http://www.ftc.gov/ogc/brfovrvw.shtm (last visited Mar. 3, 2010). A short history of the sequence of legislation granting additional power to the FTC is also available on the FTC website. See Federal Trade Commission—About Us, supra note 36. Details of the numerous such suits prosecuted by the FTC are beyond the scope of this paper.
mortgage loan when the new loan has no reasonable, tangible net benefit to the borrower), 39 packing (adding unnecessary credit insurance and other items to increase profit on the loan), 40 and equity stripping (basing a loan on the existing equity in the property without regard to the borrower’s lack of income and inability to repay). 41 Interest rates ranging from twenty percent to as high as twenty-four percent were charged to elderly, low-income borrowers. 42 The FTC also brought cases against Delta Funding Corporation for equity stripping rather than following a prudent underwriting process involving evaluation of the borrower’s debt-to-income ratio, residual income, and individualized repayment history, 43 and other subprime mortgage lenders that violated HOEPA by failing to provide required disclosures and using prohibited lending terms (such as balloon payments on loans with less than five-year terms, increased interest rates after default, and prohibited prepayment penalties). 44 The FTC’s Bureau of Consumer Protection did actively respond to consumer complaints, particularly situations in which a pattern of fraud was observed. 45 Litigating Truth in Lending claims or situations in which a lender’s sales force convinced a borrower to take out a loan at a four percent interest rate and the documentation for that loan listed a higher interest rate would clearly be within the purview of the FTC. However, the FTC would not have conducted examinations of lending institutions to evaluate their capitalization, adequacy of reserves, or underwriting practices. The FTC had neither the staff to examine lenders nor the view that the agency’s mission includes the ability to examine lenders for compliance with proper banking practices. 46

39. Id. at 8.
40. Id. at 9.
41. Id. at 7.
42. Id. at 8.
2. GAO Urges the Federal Reserve To Reconsider Its No-Examination Policy and Flags Related Issues in Its 1999 LTCM Report

The General Accounting Office (GAO) issued a report in 1999 in which it warned that the decision of the Federal Reserve Board not to examine affiliated lenders created “a lack of regulatory oversight,” because only the Fed was in a position to supervise the affiliated lenders.47 The GAO’s report discussing its investigation of the near-collapse of Long-Term Capital Management (LTCM)48 contains findings that have a disconcerting echo in light of the developments in the subprime mortgage market only a few years later. Market discipline is said to be the primary mechanism to control risk taking, but it is not effective unless creditors and counterparties can increase costs or decrease the availability of credit to customers as those customers assume greater risks.49 Not all of LTCM’s creditors and counterparties applied appropriate prudent standards in their transactions with the hedge fund.50 Furthermore, some of the analytical tools used by banks to assess LTCM’s riskiness “appeared to have been flawed.”51 The nature of this flaw is instructive. The firms apparently shared LTCM’s view that its risks were widely diversified because its positions were spread across markets around the globe. However, LTCM’s worldwide losses in August and September [1998] showed that although its risks were spread across global markets, LTCM had replicated similar strategies in each market. As a result, when its strategies failed, they failed across markets. According to the President’s Working Group report, the firm’s risk models underestimated the size of shocks and the resulting price movements that might affect world markets. Related to this, they did not fully consider the potential impact on markets of a liquidation of LTCM’s positions.52

The Fed had stressed that ensuring the soundness of individual institutions is the most prudent course of action for financial regulators. In a mild rebuke to the Fed, the GAO said that soundness is only one aspect of financial oversight, and, furthermore, “such oversight is not currently applied to all financial institutions that can originate or transmit risk and does not include effective ways to monitor and assess risks that cut across markets.”53

47. See id.; see also Binyamin Appelbaum, As Subprime Lending Crisis Unfolded, Watchdog Fed Didn’t Bother Barking, WASH. POST, Sept. 27, 2009, at A1.
48. See generally U.S. GEN. ACCOUNTING OFFICE, supra note 34. Long-Term Capital Management (LTCM), at the time one of the largest hedge funds in the United States, lost almost ninety percent of its capital between January and September 1998. Id. at 38–39.
49. Id. at 10.
50. Id. at 11. Among the reasons were that doing business with LTCM was profitable, competition for that business provided an additional incentive to relax credit standards, and “favorable economic conditions had prevailed for several years, contributing to an atmosphere in which financial firms liberalized their credit standards.” Id.
51. Id.
52. Id. at 11–12.
53. Id. at 33.
3. Treasury and HUD Issue a Joint Report on Subprime Lending Urging Fed Action

In their joint report on predatory lending, the Department of Housing and Urban Development (HUD) and the Treasury Department also recommended that the Fed exercise its power to examine the operations of affiliated entities. The Fed clearly has the authority to investigate evidence of abusive lending practices, and it should initiate a policy of engaging in targeted examinations in response to documented problems with particular lenders. The recommendation that the Federal Reserve Board “use its existing authority to issue regulations and take new enforcement steps to prevent abusive practices” is woven throughout chapter VI of the report, which discusses recommendations for reform throughout the subprime mortgage market.

C. Consumer Advocates and Academics

1. Academics and Consumer Protection Advocates Urge Action

John Taylor, president of the National Community Reinvestment Coalition, told Congress after the GAO report, “If the Fed really wants to take action against predatory lending, here is a clear opportunity.”

Three times each year, the Federal Reserve System’s Consumer Advisory Council (the Council) meets with members of the Federal Reserve Board and other interested persons. As concern grew regarding predatory lending practices and difficulties some consumers were encountering in mortgage loans obtained through subprime lenders, members of the Council conveyed their concerns to the Federal Reserve Board of Governors during these meetings. Throughout the development of the subprime lending crisis,

55. Id. at 106–07.
56. Id. at 111. Specifically, the Department of Housing and Urban Development (HUD) and the Treasury recommended that the Federal Reserve Board take the following steps: (1) Lower the HOEPA APR threshold to 8% above comparable Treasuries. (2) Include additional fees in the point-and-fee trigger, including all compensation received by the mortgage broker. (3) Define as unfair, deceptive, or abusive practices and prohibit: loan flipping; sale of single-premium products along with mortgage loan; lending without regard to borrower’s ability to repay. (4) Collect additional data items under Regulation C, including APR and “all-in” cost of credit; reasons for denial; name of parent institution. (5) Repeal the Regulation C 10 percent rule. (6) Consider conducting risk-based examinations of non-bank lending subsidiaries of bank holding companies where it has a basis to believe that such subsidiaries are violating HOEPA or otherwise engaging in predatory lending.
members of the Council sounded the alarm. For example, Council member Carolyn Carter gave specific information regarding a lender’s deficient underwriting at a 2006 meeting in which she said, “[AIMS] underwrote only on the teaser rate—[it] did not underwrite on the fully indexed rate. Much less, the worst-case scenario rate adjusted up to the maximum.” She also pointed out that, without assignee liability, protections are unlikely to be enforced by the market.

Members of the Federal Reserve Board insisted that persuasive evidence of macroeconomic harm must be produced before the Fed would change its posture regarding conducting examinations. This retrospective approach embodied unappreciated dangers. By the time irrefutable empirical evidence of macroeconomic harm can be obtained, the horse is out of the barn, and it is far too late to mitigate the harm caused by the consumer-finance entity’s failure to maintain underwriting standards when making mortgage loans.

There may be some parallels to any prosecutorial decision not to investigate or charge, but a significant difference here is the scope of potential harm. The systemic risk to not only the individual financing firm but, as we see in hindsight, to the entire economy made it particularly risky for the Fed to refuse to investigate the reports of predatory lending that were brought to its attention.

IV. CONVINCING THE FED TO EXERCISE ITS POWER TO CONDUCT EXAMINATIONS OF AFFILIATED NONBANK LENDERS

A. Variety of Vantage Points

Of course, there is a vast literature addressing regulatory capture, formalism, and other aspects of the functioning of regulatory agencies. Here I focus on a smaller subject, reflecting on some of the factors contributing to the situation in which, even when red flags are being raised, action does not follow. Perhaps we can shed some light that will help prompt those at the helm in the future to more quickly exercise the


60. Id. at 29 (“I’d like to stress that [there is more scrutiny] because of the assignee liability provision. And if you want any regulations, or any reforms, any protections to be effective, to actually be enforced by the market, you would have to pass that liability along so that the liability goes with the loan. If a loan can be washed by transferring it, then it will be transferred, and the market will not prevent those loans from being made.”).

regulatory authority they have in time to lessen the deleterious effects of future financial bubbles.

B. Viewed Through the “Individual Hero” Lens

A paradigmatic story of the “individual hero” account is captured in the classic movie, Twelve Angry Men, in which a lone holdout juror stubbornly refuses to join the rest of the jurors in convicting the defendant, eventually convincing all the other members of the jury to see the evidence his way.

There certainly are times in which a single committed individual can help a legislature avoid complacency and take action. One such example of the individual hero account is the story of former Los Angeles City Council member Hal Bernson. Earthquake preparedness was his crusade. As chair of the city council’s Ad Hoc Committee on Earthquake Recovery, he focused attention on the need for immediate action, urging that statewide disaster drills modeled on those in Japan be scheduled so that first responders would be ready in the event of an earthquake, even when the harm might not eventuate for years.

Bernson also tirelessly warned about the need to retrofit multifamily living units constructed of unreinforced masonry so that they would be structurally stronger and less likely to collapse during an earthquake. His crusade began in 1979 when he came across some safety measures that were proposed after the Sylmar earthquake in 1971, but never enacted. Engineers agreed that old brick buildings were potential death traps in a major earthquake. He decided to push for a new ordinance.62

Bernson’s retrofitting proposal was vehemently criticized.63 Opponents argued that existing buildings should continue to be exempted from the building code requirements for new construction since there was little likelihood of an earthquake happening during the remaining useful life of those buildings. They also claimed that his real goal was to create more jobs for construction industry workers who would be hired to retrofit.

The city council eventually did decide to go along with Bernson and required the retrofitting in 1981.64 Twelve years later, in January 1994, the

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63. Id. (“Property owners lobbied hard, saying the cost of retrofitting their buildings was prohibitive. [The proposal was too expensive. Useable housing would be taken off the market.] Some apartment owners bused in elderly tenants to testify that their rents would go up and they’d be out on the street if such a law were passed.”).

64. Los Angeles Municipal Code Chapter IX, article 1, division 68 was passed on January 7, 1981, and addresses earthquake hazard reduction in existing buildings. Division 68 requires retrofitting and reinforcement of multiunit dwellings in Los Angeles County to bring the dwellings up to current engineering standards for earthquake resistance. See City of Los Angeles Notices: Ordinance No. 154,807, LOS ANGELES DAILY J., Jan. 13, 1981, at 6 (the official publication of the ordinance); see also Richard Stuart Olson, The Political Economy of Life-Safety: The City of Los Angeles and “Hazardous-Structure Abatement,” 1973–1981, 4 POL’Y STUD. REV. 670, 674–76 (1985) (discussing the four key factors leading the Los Angeles City Council to adopt the 1981 ordinance: (1) the role of Hal Bernson as an
Northridge earthquake occurred. A few buildings did collapse, but the number of deaths was in the dozens, not in the thousands. The Northridge earthquake was strong enough that many more people would have died in multifamily housing units if they had not been retrofitted to be structurally stronger.

Bernson continued his advocacy of disaster preparedness after the Northridge earthquake until he retired in 2003. For example, he proposed a law that would require all residences and businesses in the City of Los Angeles to be equipped with gas valves that automatically shut off the flow of gas during strong earthquakes. At least 600,000 older structures would be affected by the law, which was aimed at reducing the number of fires fueled by gas leaks. Those opposing the proposal replayed the same dynamic that had attended the retrofitting debate, arguing that the $300 installation cost for each valve presented an unnecessary financial burden on the building owners. Hal Bernson’s effort to strengthen disaster preparedness in Los Angeles is an example of the difference that a single committed legislator can make in getting a legislative group to take action.

1. Leadership from the Head of the Agency

As Deborah Rhode has said in the context of effectively changing organizational culture within an institution, “A necessary first step is commitment from the top.” Alan Greenspan had the opportunity to influence the members of the Federal Reserve Board; he was in a position to effect change in the institution’s evaluation of underwriting standards and the implementation of its examination policies. But, as he admitted in his testimony on the Hill in October 2008, he did not anticipate the macroeconomic impact of the excesses in the subprime market and securitization of badly underwritten mortgages. Greenspan’s October 23,
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2008, testimony has been analyzed elsewhere. The key point here is that in his testimony he acknowledged that during the eighteen years he served as Chairman of the Federal Reserve Board before stepping down in January 2006, he had never contemplated the possibility that there was unacknowledged risk in the financial system. He admitted that, “those of us who have looked to the self-interest of lending institutions to protect shareholders’ equity, myself especially, are in a state of shocked disbelief. Such counterparty surveillance is a central pillar of our financial markets’ state of balance. If it fails, as occurred this year, market stability is undermined.” This statement of his “shocked disbelief” indicates that none of the repeated efforts to warn the Federal Reserve Board about problems bubbling in the subprime lending affiliates had been heard by the Chairman. As he further testified,

The whole intellectual edifice [of risk management and pricing in the derivatives market], however, collapsed in the summer of last year, because the data inputted into the risk management models generally covered only the past two decades, a period of euphoria.

Instead, the model has been fitted more appropriately to historic periods of stress, capital requirements would have been much higher, and the financial world would be in far better shape today, in my judgment.

In his testimony, Greenspan confirmed that his leadership of the Federal Reserve Board had not even considered the possibility that the deregulated market for mortgage lenders, and the Fed’s decision to refrain from fully exercising its power to examine mortgage lenders, could conceivably lead to lending practices in the home mortgage market that contributed to the crisis in the fall of 2008. He testified,

In 2005, I raised concerns that the protracted period of underpricing of risk, if history was any guide, would have dire consequences. The crisis, however, has turned out to be much broader than anything I could have imagined. It has morphed from one grip[ped] by liquidity restraints to one in which fears of insolvency are now paramount.

When the leader of an institution cannot entertain, at least for the sake of argument, the observations of the members of its own advisors, such as the Consumer Advisory Council, the institution can be blindsided. If, instead, Greenspan had been open to the possibility that the contrarian views that clashed with his own belief in the self-correcting power of the free market might be bringing to his attention problems that could be addressed by the Federal Reserve Board, his leadership might have helped the Board take action to effectively address those problems much earlier than 2008.

72. Greenspan Testimony, supra note 17, at 17.
73. Id. at 18–19.
74. Id. at 15.
2. Did Groupthink Impede the Effectiveness of Warnings Voiced by Other Individuals Within the Fed?

Corporate governance scholars have long warned against the dangers of groupthink developing among the members of an entity’s board of directors.\(^7\) Calls to address what social psychologists refer to as “groupthink” in corporate boardrooms were raised with increasing urgency as details emerged regarding mismanagement and failures of board oversight at companies including Waste Management, Sunbeam, Cendant, Enron, Global Crossing (petition in bankruptcy filed after revelation that long-term contracts were improperly booked as revenue), Tyco, Adelphia (board members not aware of material related-party transactions), and WorldCom. Irving Janis has described groupthink as “a mode of thinking that people engage in when they are deeply involved in a cohesive in-group.”\(^7\)

In the wake of Enron’s abrupt collapse in 2001,\(^7\) and as details have emerged regarding the lax oversight exercised by the Enron board of directors in connection with the transactions that brought down the company,\(^8\) calls to address groupthink in corporate boardrooms were raised with new vigor.\(^7\) One of the crucial difficulties when groupthink has taken hold is getting members of the in-group to voice (and listen to) contrarian views. A number of mechanisms for accomplishing this have been proposed, including empowering shareholders, particularly institutional shareholders, to take a more direct role in the nomination process or setting aside seats on the board for institutional shareholders. Troy Paredes’s devil’s advocate proposal is one of a number of proposals

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\(^7\) See, e.g., Lynne L. Dallas, Proposals for Reform of Corporate Boards of Directors: The Dual Board and Board Ombudsman, 54 WASH. & LEE L. REV. 91, 94 (1997).

\(^8\) IRVING L. JANIS, VICTIMS OF GROUPTHINK 9 (1972). When members of a group, such as a board of directors, are in the grip of groupthink, they unconsciously participate in shared illusions of superiority that hinder critical reflection and reality testing, thus leading groups to faulty judgments. See id.; see also James D. Cox & Harry L. Munsinger, Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion, LAW & CONTEMP. PROBS., Summer 1985, at 83, 103–08 (applying groupthink analysis to decisions by corporate boards); Robert J. Haft, Business Decisions by the New Board: Behavioral Science and Corporate Law, 80 MICH. L. REV. 1, 37–49 (1981) (analyzing corporate board decisions for instances of groupthink).


intended to lessen the likelihood that a board will fall prey to groupthink. Paredes proposed creating a role for a member of a corporation’s board to act as “chief naysayer,” essentially a devil’s advocate, to counter CEO overconfidence, which behavioral corporate finance posits can lead to good-faith mismanagement.80 Perhaps we can analogize the devil’s advocate board member to an agency insider who is willing to express contrarian views.

There was an insider within the Fed who advocated that the Fed give greater oversight to financing companies affiliated with federally regulated banks. While he may not have occupied a true devil’s advocate position as proposed by Paredes, former Federal Reserve Governor Gramlich did urge Greenspan to exercise the Fed’s ability to examine lenders to address unfair and deceptive loans as it was empowered to do under the statutory grant in HOEPA.81 Although Gramlich characterized his earlier suggestions to Greenspan as rather mild, in 2007 he publicly stated that the Fed had not been routinely examining subprime lenders who were affiliated with banks, holding companies, or thrifts.82 Gramlich then explicitly called attention to the regulatory gap:

This all sets up what I will call a giant hole in the supervisory safety net. In the prime market, where we need supervision less, we have lots of it. In the subprime market, where we badly need supervision, a majority of loans are made with very little supervision. It is like a city with a murder law, but no cops on the beat.83

He also notes that it is crucial to supervise all lenders in the subprime market, whatever mechanism is used.84 Although some scholars have argued that, in certain circumstances, regulating only a subset of firms could promote efficiency,85 Gramlich went on to observe that

82. Id. at 261 (“[T]hirty percent of subprime loans are made by affiliates of banks, holding companies, or thrifts. These affiliates are in a hybrid status—they typically are not supervised on a three-year basis by federal supervisors, though the supervisors do check in to the head office’s routines for keeping affiliates in compliance. They are also subject to specific examination if problems are noted, through complaints, suits, or whatever.”).
83. Id. at 262. Gramlich elaborates on this further in his book and recommends solutions to address the problem of lax supervision. EDWARD M. GRAMLICH, SUBPRIME MORTGAGES: AMERICA’S LATEST BOOM AND BUST 91–92 (2007).
84. Gramlich, supra note 81, at 262. On July 17, 2007, the Federal Reserve and the Office of Thrift Supervision announced a joint program under which they would begin supervising a sample of the affiliates. Id.
85. See, e.g., AYRES & BRAITHWAITE, supra note 61, at 6 (“The thesis of Chapter 5 is that in some regulatory settings, regulating only an individual firm (or a subset of the firms) in an industry can promote efficiency by avoiding the costs associated with industry-wide intervention or laissez-faire. The existence of a single (or a few) competitive firm[s] can
[t]he subprime market is pretty competitive and there will always be an incentive to cheat—to ignore this law or that regulation. Bringing all lenders into the tent means that all are playing by the same rules, which hopefully are effective rules. A long list of subprime mortgage abuses could be easily eliminated by expanding the lending supervision—from inadequate efforts to document borrowers’ ability to repay the loan, failure to escrow taxes and insurance, or some of the common predatory lending practices.  

Why didn’t his warning get traction and lead the Fed to take action much earlier than it did?

3. Energetic Contrarian Cannot Move an Unwilling Group

Ross Perot’s tenure as a contrarian member of the General Motors (GM) board of directors may provide a helpful illustration. Perot goaded the leadership of GM to stay in closer touch with their dealers and customers during his service as a member of the GM board after the company bought out Electronic Data Systems (EDS). He raised questions about customer complaints of oil leaking from Cadillacs and dealer complaints about the quality of finishing material used. Rather than welcoming the contrarian view and addressing the hitherto unexplored problems Perot raised, the CEO and Chairman of the Board summarily rejected the issues as being unimportant. The corporation eventually bought out Perot’s interest and he left the board without his board service having effected much measurable change in the corporate culture.

The limits of the individual hero lens, locating power to change institutional response in the prescient individual actor, are also apparent in the case of the intransigence of the Fed in its decade-long adherence to the 1998 decision to refuse to exercise the full extent of its examination power. Governor Gramlich’s efforts to push for change did not eventuate in an institutional change in policy. As a result of the Fed’s continuation of the 1998 policy the underwriting practices of the subprime financing affiliates were not effectively examined for years, even after Gramlich had voiced his concerns.

have a dramatic effect on the competitive conduct and performance of an entire industry.”). The potential downside of regulating only part of the home mortgage industry is now painfully apparent.

86. Gramlich, supra note 81, at 262.
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C. Cognitive Decision Theory as a Plausible Explanation for the Continuation of the Policy of Not Examining Affiliated Lending Entities Until Change Was Announced on September 14, 2009

More information about the interrelated causes of the recent difficulties in the financial markets is likely to emerge in the months ahead. The observations in this section of the paper are tentative and subject to revision as additional information comes to light. The Financial Crisis Inquiry Commission (the Commission), chaired by Phil Angelides, has undertaken a wide-ranging investigation of the causes of the financial and economic crisis that came to public attention in the fall of 2008.89 Among other activities, the Commission is specifically investigating the role of

(A) fraud and abuse in the financial sector, including fraud and abuse towards consumers in the mortgage sector; (B) Federal and State financial regulators, including the extent to which they enforced, or failed to enforce statutory, regulatory, or supervisory requirements; . . . (G) capital requirements and regulations on leverage and liquidity, including the capital structures of regulated and non-regulated financial entities; . . . (I) lending practices and securitization, including the originate-to-distribute model for extending credit and transferring risk; . . . (S) the legal and regulatory structure governing financial institutions, including the extent to which the structure creates the opportunity for financial institutions to engage in regulatory arbitrage; [and] (T) the legal and regulatory structure governing investor and mortgagor protection.90

As the Commission continues its work, more information is certain to become public which will more fully inform analysis of the decisions made by the Federal Reserve Board between January 1998 and September 2009. But the information currently available is sufficient to venture some preliminary observations about the likelihood that biases and heuristics influenced the members of the Federal Reserve Board.

1. The Effects of Cognitive Biases

Psychologists building on Herbert A. Simon’s theory of “bounded rationality”91 have explored various heuristics and biases through which people filter information,92 developing Simon’s view that individual

decision makers are inevitably constrained by limited cognitive resources as they consider information and make decisions. Among those biases are the confirmation bias (also referred to as confirmatory bias), overconfidence bias, bounded search, and status quo bias. People frequently interpret new information “in ways that serve their interests or preconceived notions.”

This confirmation bias leads to a “tendency to exaggerate a correlation when doing so confirms one’s hypothesis or to underestimate a correlation when one does not subscribe to a hypothesis that might explain the correlation.”

There is evidence, for example, that confirmation bias may affect auditors evaluating a corporation’s financial statements; it is likely that it also influences other professionals advising the company, including the lawyers representing the corporation.

If the members of the Federal Reserve Board were affected by confirmation bias, they would tend to misread new evidence as supporting their initial hypothesis regardless of how a more objective person might interpret the same evidence. If their initial hypothesis was that the home mortgage market would function best with less regulatory oversight, then additional evidence brought to their attention after that initial perspective had been formed would be viewed as supporting that hypothesis. Also note the impact of disconfirmation bias, which refers to setting higher standards of evidence for hypotheses that challenge the evaluator’s beliefs and


95. Jon D. Hanson & Douglas A. Kysar, Taking Behavioralism Seriously: The Problem of Market Manipulation, 74 N.Y.U. L. REV. 630, 649 n.71 (1999) (noting that a decision-maker’s need to view incoming data as being consistent with his preexisting beliefs can strongly influence the person’s assessment of that data as supporting the expected result (citing Dennis L. Jennings et al., Informal Covariation Assessment: Data-Based Versus Theory-Based Judgments, in JUDGMENT UNDER UNCERTAINTY, supra note 92, at 211, 227–30); see also Matthew Rabin, Psychology and Economics, 36 J. ECON. LITERATURE 11, 29 (1998); Jean R. Sternlight & Jennifer Robbennolt, Good Lawyers Should Be Good Psychologists: Insights for Interviewing and Counseling Clients, 23 OHIO ST. J. ON DISP. RESOL. 437, 454 (2008) (“[P]eople unconsciously tend to seek out additional information that confirms their already existing views and disregard conflicting information, rather than attempting to systematically gather accurate information.” (citing Nickerson, supra note 94)).

96. See Jeffrey J. McMillan & Richard A. White, Auditors’ Belief Revisions and Evidence Search: The Effect of Hypothesis Frame, Confirmation Bias, and Professional Skepticism, 68 ACCT. REV. 443, 463 (1993) (calling for further investigation into “the possibility suggested by [their] study that auditors who begin the audit judgment process feeling that material errors are unlikely may be inclined to downplay evidence that indicates that material errors may exist”); see also Don A. Moore et al., Conflict of Interest and the Intrusion of Bias, 5 JUDGMENT & DECISION MAKING 37, available at http://journal.sjdm.org/10/91104/jdm91104.pdf.
expectations and overweighting positive confirmatory evidence while giving less attention to disconfirmatory evidence.  

In addition, researchers have found that when people encounter a more difficult judgment task involving ambiguous information and calling for abstract thinking and interpretation, they exhibit a stronger degree of overconfidence bias.  It perhaps is stating the obvious to note that a high degree of abstract thinking involving ambiguous information is involved in the types of judgment tasks encountered by the members of the Federal Reserve Board. Furthermore, researchers have found evidence that we are blind to our own bias and remain so, even after concerted attempts are made to educate us and we think we are correcting for that bias. Cognitive dissonance, a related effect, refers to the selective perception involved when people discount evidence that contradicts their beliefs. Charles Lord has noted that “judgments about the validity, reliability, relevance, and sometimes even the meaning of proffered evidence are biased by the apparent consistency of that evidence with the perceiver’s theories and expectations.”

Of course, there are significant critiques of the research on biases. One branch of psychology research, fast and frugal heuristics, for example, focuses on the task environment in which particular decisions are being made and posits that the rationality of a heuristic can only be assessed in the context of the environment in which that heuristic is used. Others have argued that behavioral researchers themselves are subject to “citation bias,” overfocusing on instances in which nonrational bias is observed and underemphasizing research indicating otherwise. Those controversies within the field, however, do not diminish the potential value that the


100. See LEON FESTINGER, A THEORY OF COGNITIVE DISSONANCE 32–47 (1957) (positing that the pressure to reduce inevitable postdecision dissonance will be manifested in efforts to focus on the merits of the alternative selected and to increase cognitive overlap of the various alternatives).

101. Lord et al., supra note 97, at 2009.


research on cognitive biases has to illuminate the decisionmaking process and to shed some light on the failure of the members of the Federal Reserve Board to perceive and act upon the warnings that were presented to them. It is well established that cognitive biases can have the effect of diminishing a person’s “capacity to perceive danger signals.”\(^{104}\) Cognitive biases can have a significant effect on a person’s ability to correctly assess the significance of the new information that he or she encounters.

Members of the Federal Reserve Board are as likely to be subject to cognitive biases as are other persons. Cognitive decision theorists have posited that policy makers, as well as other individuals, can also be influenced by cognitive and behavioral biases.\(^{105}\) Although it would be difficult to satisfactorily prove this assertion with empirical evidence, consideration of possible biases may shed light on the Federal Reserve Board’s continued commitment to the stance announced when the January 1998 notice was published and which lasted until that policy was withdrawn in September 2009, after Bernanke replaced Greenspan. The fact that the decision to extend the policy of not examining subprime-affiliated lenders in response to consumer initiated complaints was formalized in a public document might also have reinforced the effects of confirmation bias. As Donald Langevoort has observed, “[O]nce executives have committed to a course of action, their subsequent survey of information is strongly biased to bolster their choice—especially when their choice is public, and they can

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be held accountable for their decisions.”

The effects of confirmation and disconfirmation bias are amplified in deliberating groups, resulting in a polarizing effect.

The members of the Federal Reserve Board, a deliberative body, are not immune to the effects of group polarization.

2. The Deregulatory Project as an Availability Cascade Generating Collective Availability Errors

As Timur Kuran and Cass Sunstein have noted, “[c]ognitive psychologists [view the availability heuristic [the perceived likelihood of any given event is tied to the ease with which its occurrence can be brought to mind] as a key element of individual judgment and perception.”

The probability assessments individuals make are often based in part on how easily we can think of relevant examples. Kuran and Sunstein argue that “[the availability] heuristic interacts with identifiable social mechanisms to generate availability cascades . . . through which expressed perceptions trigger chains of individual responses that make these perceptions appear increasingly plausible through their rising availability in public discourse.”

They go on to note that “[u]nder certain circumstances . . . they will generate persistent collective availability errors: widespread mistaken beliefs grounded in interactions between the availability heuristic and [certain] social mechanisms. . . . The resulting mass delusions may last indefinitely, and they may produce wasteful or even harmful laws and policies.”

It is worth considering whether the movement to dismantle regulatory controls and lack of interest in exercising oversight through examining subprime lending entities affiliated with bank holding companies is an example of just such a collective availability error. Others have noted


107. Cass R. Sunstein, Deliberative Trouble? Why Groups Go to Extremes, 110 YALE L.J. 71, 74 (2000) (surveying the literature on polarization of deliberating groups and concluding that there is strong evidence that “members of a deliberating group predictably move toward a more extreme point in the direction indicated by the members’ predeliberation tendencies”).


111. Id.
“the global [move] toward market-friendly government policies” as an example of an availability cascade.\(^{112}\)

What I am positing here is that the Federal Reserve Board’s unwillingness to examine lending activity that was clearly within their regulatory purview can be viewed as an availability error that had widespread deleterious macroeconomic effects. It is important to note that the majority of the literature on the availability heuristic’s effects on risk assessment focuses on assessing the danger of overemphasizing overblown scares and “populist firesstorms.”

The behavioral science literature suggests that unconscious bias can be at work in decisions reached by regulators.\(^{113}\) It is understandably difficult to design experiments that would provide empirical evidence of regulators’ cognitive and behavioral biases. But the existence of such biases would help to explain how the members of the Federal Reserve Board, individually and collectively, could turn away attempts by outside stakeholders, including the members of their own Consumer Advisory Council, who were attempting to alert the Fed to the dangers of the 1998 decision to publicly announce that a portion of the mortgage lending market would no longer have effective oversight. If the members of the Federal Reserve Board were subject to the confirmation bias, they would discount new information that called into question the course of [in]action set out in the January 1998 letter.\(^{114}\) The Federal Reserve Board’s refusal to give credence to the growing body of information about the unfair lending practices in the subprime mortgage market can be seen as an instance of confirmation bias. A person influenced by confirmation bias would be likely to do precisely what the Federal Board did: disregard new information that conflicted with the belief that deregulation of financial markets would be on balance beneficial and that a free market would correct any deleterious effects.

112. Id. at 376. See generally Amos Tversky & Daniel Kahneman, Availability: A Heuristic for Judging Frequency and Probability, in JUDGMENT UNDER UNCERTAINTY, supra note 92, at 163 (reviewing studies investigating the psychological mechanisms through which people estimate the likelihood that a possible future event will occur).

113. See Arlen, supra note 105, at 1769; Choi & Pritchard, supra note 105, at 20–42 (noting that SEC commissioners and staff not only share the same cognitive defects that all persons are subject to, but also, as experts, may be unable to see past their own set of biases); Donald C. Langevoort, Behavioral Theories of Judgment and Decision Making in Legal Scholarship: A Literature Review, 51 VAND. L. REV. 1499, 1519 (1998) (“Less attention has been devoted to whether courts or regulators are likely to be biased along the lines suggested in the behavioral literature, perhaps because bureaucratic activity seems more organizational than individual.”); Rachlinski & Farina, supra note 105, at 558–61 (discussing the role of expertise in increasing cognitive errors in some situations); Rizzo & Whitman, supra note 105, at 724 (suggesting that policymakers exhibit cognitive and behavioral biases).

114. See Sternlight & Robbenmolt, supra note 95, at 454 (“[P]eople unconsciously tend to seek out additional information that confirms their already existing views and disregard conflicting information, rather than attempting to systematically gather accurate information.” (citing Nickerson, supra note 94, at 175)).
The status quo bias, the idea that individuals prefer actions that continue the status quo rather than those that represent a change, suggests that the members of the Board of Governors would prefer to maintain the course of action set out in the January 1998 notice and would be unlikely to affirmatively act to change course until presented with dramatic, undeniable evidence that the January 1998 policy could no longer be maintained.\footnote{See Russell Korobkin & Chris Guthrie, *Heuristics and Biases at the Bargaining Table*, 87 Marq. L. Rev. 795, 802 (2004) ("All other things equal, individuals on average tend to prefer an option if it is consistent with the status quo than if it requires a change from the status quo." (citing Russell Korobkin, *The Endowment Effect and Legal Analysis*, 97 Nw. U. L. Rev. 1227, 1231–42 (2003))); see also William Samuelson & Richard Zeckhauser, *Status Quo Bias in Decision Making*, 1 J. Risk & Uncertainty 7, 8 (1988).}

As we consider what changes to make to the regulation of the financial services markets in the United States,\footnote{Proposals to dramatically overhaul the system of oversight of financial institutions are currently under consideration.} it is important to bear in mind that there may be some significant advantages to building in ways to address the effects of biases, heuristics, and cognitive illusions that may affect the regulators implementing the new requirements. As Stephen J. Choi and A. C. Pritchard have noted, "[M]arket forces are unlikely to correct the biases affecting monopolistic regulators. Without competitive pressure, biases may flourish."\footnote{Choi & Pritchard, * supra* note 105, at 44.} Their discussion of the cognitive biases likely to affect regulators at the SEC is equally applicable to the members of the Federal Reserve Board.\footnote{We posit that regulatory decisionmakers with monopoly authority—such as the SEC with respect to most domestic securities regulation—should have to overcome a strong presumption against intervention to correct cognitive biases.”}.\footnote{Id. ("We posit that regulatory decisionmakers with monopoly authority—such as the SEC with respect to most domestic securities regulation—should have to overcome a strong presumption against intervention to correct cognitive biases.”).}

V. IMPLICATIONS OF APPLYING COGNITIVE PSYCHOLOGY PRINCIPLES IN CONNECTION WITH DECISIONS MADE WITHIN A LAW FIRM

On a smaller scale, perhaps understanding the cognitive factors involved in accurate risk assessment may shed light on the dynamics affecting the likelihood that a law firm opinion committee will be able to effectively rein in an individual partner who wants the committee to approve language in an opinion letter to support a client’s transaction. Confirmation bias, overconfidence bias, bounded search, and status quo bias are likely to influence the members of the opinion committee as they work through the decisions regarding the language that will be included in the opinion letter which is ultimately issued.

Other scholars are examining the context in which the legal opinions supporting transactions that the IRS later determined to be abusive tax shelters were given.\footnote{The much-anticipated book by Mitt Regan and Tanina Rostain promises to shed substantial light on this subject. *Tanina Rostain & Milton C. Regan Jr., Confidence Games: Lawyers, Accountants, and the Tax Shelter Industry* (forthcoming 2011).} At this point, it is worth considering the question of whether cognitive biases may have come into play when the partners on the opinion committee at Jenkins & Gilchrist or Sidley Austin, who were not
personally involved in structuring the transactions being opined on, were considering whether or not to allow the problematic sections to be included in the legal opinions that were issued. Cognitive biases could have made it more difficult to accurately assess the risks presented by the opinion letters that Paul Daugerdas at Jenkens & Gilchrist, for example, urged the firm to sign off on in connection with his tax-shelter technique using contingent liabilities to generate artificial losses.¹²⁰

Tanina Rostain has pointed out the protective function of (1) the professional judgment of the other tax partners at the firm as well as (2) the usefulness of the expertise of the partners engaging in a sophisticated corporate practice in continuing to develop the partner’s judgment regarding whether or not a transaction does have an underlying economic basis.¹²¹

But the experience at even a leading firm like Sidley Austin is that the firm’s opinion evaluation process did not protect the firm from issuing opinion letters supporting transactions that were later determined to be abusive tax shelters. Could other partners at Jenkins & Gilchrist or Sidley Austin have taken action to effectively rein in the opinions written to support those transactions? Determining why they were not able to prevent the opinions from being issued could shed light on the dynamics within the organizations, which may be useful in helping avoid similar difficulties.

VI. CONCLUSION

The Federal Reserve Board issued a notice in January 1998 declaring that the Fed would not perform consumer-initiated examinations. The Federal Reserve Board maintained that policy position throughout the growing crisis in the subprime lending market, which became increasingly evident through the following decade. The Federal Reserve Board finally changed its examination policy in September 2009, not in response to the urging of its own Consumer Advisory Council, the GAO, HUD, or Treasury Department, or even the views of a somewhat contrarian member of the Federal Reserve Board, but only after the crisis in the financial markets became a public debacle in the fall of 2008. Why did the Federal Reserve


¹²¹ Tanina Rostain, Pockets of Professionalism, 54 STAN. L. REV. 1475, 1483 (2002) (“During our interview, Williams returns time and again to the problem of pressure—the pressure to arrive at the tax result favored by a client—and the buffer provided by the firm.”).
Board maintain for so long the January 1998 policy? Cognitive decision theory gives a plausible lens through which to view the inaction of the Board: confirmation bias, overconfidence, groupthink, bounded search, and status quo bias have some explanatory power here. Corrective measures for those biases in regulatory decisionmaking processes and determination of the interaction between various biases remain fruitful subjects for further research. What is clear is that decision makers in other organizations, including partners in law firm opinion committees, can consider the Federal Reserve Board’s reluctance to withdraw its January 1998 policy an example of the dangers of failing to consider contrarian views.