U.S. Banking De-Regulation, Financial Engineering, and Bankruptcy Reform: How Banks Took Control over Consumer Insolvency Law

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"We have had a general lack of shame or personal responsibility that used to be associated with paying bills or not paying bills and the filing of bankruptcy... I hope this bill does make [consumer]bankruptcy more embarrassing—and more difficult. In fact, I plead guilty that that is a motive behind our legislation."

---U.S. Senator Charles Grassley (R-Iowa), Chairman of the U.S. Senate Judiciary Committee, 2000

Introduction

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (Pub. L. 109–8, 119 Stat. 23, enacted April 20, 2005) ("BAPCPA") is the most significant revision of the U.S. Bankruptcy code since 1978. Initially, this pro-bank/creditor sponsored legislation was developed in response to pro-debtor policy recommendations that were included in the final 1997 report of the U.S. National Bankruptcy Review Commission.[3] In the bank promoted narrative, which became one of the most costly lobbying campaigns in U.S. history,[4] the purported impetus for the bankruptcy reform legislation was to reverse the cultural decline in American values that were asserted to underlie the erosion of personal financial responsibility and the growth of

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[3] The official report was submitted to the U.S. Congress. See U.S. National Bankruptcy Review Commission, Bankruptcy: The Next Twenty Years (1997). Available at http://govinfo.library.unt.edu/nbrc/report/01title.html.

[4]See Elizabeth Warren, *"The Phantom $400,"* Journal of Bankruptcy Law and Practice, Vol. 13, No. 2 (2004):77-99 and Elizabeth Warren, *"The Market for Data: The Changing Role of Social Sciences in Shaping the Law,"* Wisconsin Law Review, Vol. 2002, No.1., (2002[a]):1-43.

unprecedented levels of discharged consumer debt. Of course, bank lobbyists fought hard to exclude institutional responsibility in the public discourse. From their self-interested perspective, the problem and solution focused on changing societal norms that encouraged unrestrained consumer behavior rather than address those new retail banking practices that contributed to the growth of the credit bubble and associated surge in consumer bankruptcies.

Not surprisingly, this bankruptcy reform legislation featured much more stringent criteria for debtors to qualify for "fresh start" Chapter 7 bankruptcy. However, by the time that the bankruptcy reform legislation passed in 2000 and was finally enacted in 2005, the financial services industry had undergone a profound transformation as banking deregulation accelerated the rise of "*Too Big to Fail*" Financial Services Conglomerates ("FSCs") in the early 2000s. Indeed, as Wall Street's financial engineers developed more sophisticated structured investment products and complex financial derivatives, their investment banks demanded increasing volumes of "retail" consumer debt, regardless of loan quality.[5] Moreover, with trillions of dollars of derivatives trading revenues based on consumer debt at stake, BAPCPA's role as the "third" pillar of Wall Street's legislative agenda assumed much greater importance in reducing the volatility of consumer debt portfolios that constituted the underlying assets of Wall Street's new generation of investment securities and financial derivatives.

This article examines the recent legislative history of NACBA and its significance to current bankruptcy law through the critical lens of the *Financialization* of American society. In this context, *Financialization* is defined as the ascendance of the Financial Services industry through economic deregulation and the shift to market driven public-policy. In the process, it facilitates the pursuit of an ever-greater share of national income and political power by Wall Street to the detriment of the overwhelming majority of Americans. As will be discussed, the financial services industry initiated an audacious national legislative campaign in the late-1990s that was designed to dramatically expand the economic scale and financial scope of its next

[5] The official U.S. government investigative report on the factors that were responsible for the 2007-09 Financial Crisis includes subpoenaed testimony of many key financial services executives and bank division managers that provide important information that directly impacted the decisions of Financial Services Conglomerates during this period. The rapid expansion of consumer debt, subprime loans, and overall decline in consumer loan quality is examined in Chapter 6, *"Credit Expansion,"* in U.S. Financial Crisis Inquiry Commission (FCIC), The Financial Crisis Inquiry Report, Authorized Edition: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States, Washington, DC. (2011). Available at https://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf.

generation of financial services products.

To achieve their de-regulation objectives, the major money center banks allocated a staggering amount of resources on lobbying activities during this period. For example, between 1998 and 2014, Citigroup spent nearly $100 million lobbying the federal government. A conservative estimate of the combined expenditures of the top ten FSCs and their precursors[6] on lobbying the federal government during this period is at least $600 million.[7] Prior to the Financial Crisis of 2007-09, this legislative campaign can be divided into three overlapping phases: (a) banking deregulation (1999), (b) derivatives trading deregulation/financial engineering innovation (2000), and (c) consumer bankruptcy reform (2000, 2005). By the time BAPCPA was finally enacted in 2005, the financial services industry had fundamentally reshaped the national banking regulatory structures, sharply reduced the prudential supervision of a new generation of financial investment products and derivatives trading while influencing the moral/ethical values of American society that shaped the debate over the *deserving debtor*.

Banking Deregulation and the Rise of Money Center Banks

Until recently, banking has been one of the most stringently regulated industries in the United States. Since the Great Depression, the *Glass-Steagall Banking Act of 1933* has constituted a key statutory cornerstone of the federal regulatory system for national- and state-chartered commercial banks. It followed the *McFadden Act of 1927* that restricted bank branching within states and prohibited branch banking across state lines.[8] The latter played a crucial role in limiting the economic growth, geographic scale, and organizational efficiency of regional and national banks through the 1970s while preserving the supervisory authority of state regulators and the operational viability of small community banks.[9] This is reflected in the

[6] For example, MBNA credit card company was the largest single financial contributor to the Presidential campaign of George W. Bush in 2000. Bank of America acquired MBNA in 2006.

[7] According to the Center for Responsive Politics ("CRP"), as of 2008, Citigroup ranked as the 16th largest political campaign contributor in the United States. In addition, Citigroup employees donated over $23 million between 1989 and 2006; 49% was contributed to Democrats and 51% to Republicans. See *"Citigroup Lobbying,"* Center for Responsive Politics. Available at http://www.opensecrets.org/lobby/clientsum.php?id=D000000071.

[8] In the context of the U.S. dual banking system, the McFadden Act forbade interstate branching by federally chartered banks. However, it leveled the playing field for national banks in competition with state-chartered banks by allowing them to open branches as permitted by the respective state law. The U.S. Federal Reserve subsequently extended the ruling that prohibited branching to include all state-chartered banks regulated by the Federal Reserve.

[9] The Douglas Amendment to the *Bank Holding Act of 1956* was enacted to prevent bank holding companies from

historically diffuse structure of the U.S. banking system with thousands of small state-chartered banks and a much lower number of medium and large nationally-chartered banks.

Overall, there were about 12,800 independent banks in 1960 (peaking at 13,000 in 1965) with the top ten banks accounting for 21 percent of total assets.[10] As recently as 1975, not a single state permitted out-of-state Bank Holding companies ("BHCs") to purchase in-state banks; only fourteen states permitted statewide branching.[11] Significantly, the primary objective of these branching regulations was to curb the ability of large, nationally-chartered banks from competing against local state-chartered community banks. In the process, they sought to limit the concentration of economic and political power of large banks that traditionally allied against farmers and other populist groups since the late Nineteenth Century.

During the 1980s and 1990s, regulatory restrictions on intra- and inter-state branching were steadily eroded. In fact, by 1990, every state except Hawaii permitted out-of-state BHCs to acquire in-state banks; only three states prohibited statewide branching.[12] With the enactment of the *Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994* and its implementation in 1997, the remaining restrictions on bank branching and BHCs' ownership of multiple banks were rescinded.[13] As a result, the U.S. banking system experienced an unprecedented wave of acquisitions, mergers, and industry consolidation. From a peak of about 13,000 independent banks in 1965, this total declined only modestly (-3.8%) to about 12,500 in 1980. During the 1980s, however, the number of independent banks fell precipitously (-25.6%) to nearly 9,300 in

evading the branching restrictions imposed by the *McFadden Act* as well as other state banking regulations by purchasing banks in other states and operating them as branches. It also granted the Federal Reserve broader regulatory powers over bank holding companies that sought to circumvent restrictions on ownership stakes of nonbank companies.

[10] Hubert P. Janicki and Edward Simpson Prescott, *"Changes in the Size Distribution of U.S. Banks: 1960–2005,"* Federal Reserve Bank of Richmond, Economic Quarterly, Vol. 92, No. 4 Fall, (2006): 291-2 and Kenneth D. Jones and Tim Critchfield, *"Consolidation in the U.S. Banking Industry: Is the 'Long, Strange Trip' About to End?"* FDIC Banking Review, Vol. 17, (2005): 31–61.

[11] Jith Jayaratne, and Philip E. Strahan, *"The Benefits of Branching Deregulation,"* Federal Reserve Bank of New York, Economic Policy Review, Vol 3, No. 4, (1997): 13–15.

[12] Jayaratne, and Strahan, (1997): 13–15.

[13] The Act resulted in the increased the supervisory role of the Federal Reserve over BHCs' ownership of nonbanks. Also, for banks seeking to enter new state and regional markets, it required the prudential supervision and approval of the Office of the Comptroller of the Currency 'OCC').

1990 and then dropped even more sharply (-19.4%) to about 7,500 only five years later in 1995. In 2005, the total number of independent banks had fallen 7.5 percent to 6,500.[14]

Accordingly, this phase of bank industry consolidation is reflected in the rapidly growing size of banks and concentration of bank assets. This is mirrored throughout the distribution of banks in the financial services industry: small, medium, and large. Incredibly, the corporate assets of the top ten largest banks soared from 21percent in 1960 to almost 60 percent in 2005.[15] For ambitious risk-taking banks, this was an ideal period to receive favorable regulatory approval to absorb smaller community banks, to merge with larger competitors, and to integrate new information technology for developing more efficient corporate synergies, economies of scale, and mass marketing campaigns. Hence, the end of restrictions on bank branching spawned the ascendance of *"Too Big to Fail"* multinational money center banks such as Citibank, Bank of America, and Wells Fargo at the end of the 1990s.[16] With this dramatic increase in economic and political power, Wall Street confidently embarked on the next phase of banking de-regulation that focused on dismantling of the *Glass-Steagall Banking Act of 1933.*

Banking Deregulation and the Rise of Financial Services Conglomerates

A key provision of the *Glass-Steagall Banking Act* was the establishment of a regulatory "firewall" between retail banking and investment banking while limiting the types of permissible financial speculations. It also prohibited banks from acquiring insurance companies and established the national Federal Deposit Insurance Corporation ("FDIC"). The latter was intended to restore trust in the U.S. banking system by insuring depositors' savings accounts in the event of a bank insolvency. Within this statutory framework, most banks operated within their local communities and focused on careful loan underwriting and loss mitigation. This was based on the *Three C*'s of retail banking: *Character* (honesty and reliability to repay loans), *Capital* (available assets to repay loans in the event of insufficient income), and *Capacity* (ability to repay loans based on current income and existing debts). Significantly, the bank loan

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[14] See Janicki and Prescott, (2006), pp. 291-293; and Jones and Critchfield, (2005), pp.

[15] See Janicki and Prescott, (2006), p. 292.

[16] For discussion of the distinction between the processes of bank consolidation (rise of national money center banks) and bank conglomeration (rise of financial services conglomerates), see Robert D. Manning, <u>Credit Card Nation: America's Dangerous Addiction to Debt</u>, Chapter 3, (2000).

approval process was largely based on personal knowledge of the borrower with supplemental information provided by local credit reporting bureaus.

The enactment of the *Gramm–Leach–Bliley Act* ("GLBA") or *Financial Services Modernization Act* ("FSMA") *of 1999* profoundly changed this regulatory landscape. It marks the beginning of the *Modern Era of Banking Deregulation* by statutorily permitting the formation of Financial Services Conglomerates ("FSCs"). The industry defining precedent began with the illegal merger of Citibank with Travelers Group on April 6, 1998. The new corporate entity, Citigroup, spawned a $140 billion company with assets of almost $700 billion.[17] A key synergy of the merger was that Travelers could legally market mutual funds and insurance to Citicorp's retail customers while providing the banking divisions access to an expanded client base of investors and insurance buyers. During the consummation of this illegal union, Citigroup was granted a special waiver by federal regulators while the U.S. Congress passed the *FSMA* that legalized the corporate structure of FSCs.[18] By consecrating the illegal union of Citibank and Travelers, the *FSMA* permitted Citigroup to acquire a wide range of consumer financial services companies that offered "one-stop" shopping for retail banking services, insurance, brokerage, wealth management, and high-cost "subprime" consumer financial products/services. Not incidentally, it also allowed FSCs to conduct "wholesale" investment banking activities with their "retail" banking divisions. This was crucial to the next phase of banking deregulation.

The key assumption of FSCs was that corporate integration and marketing synergies would produce lower cost retail bank products/services to consumers and yield higher profits/returns to investors.[19] Hence, the *FSMA* constitutes the statutory foundation of the "modern" bank holding structure of FSCs. Upon the enactment of the *FSMA* in November 1999, its chief architect--Robert Rubin--immediately resigned as U.S. Secretary of Treasury to become

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[17] See Mitchell Martin, *"Plan to Merge in Record $70 Billion Deal,"* THE NEW YORK TIMES, April 7, 1998. Available at http://www.nytimes.com/1998/04/07/news/citicorp-and-travelers-plan-to-merge-in-record-70-billion-deal-a-new-no.html.

[18] The *Glass-Steagall Act* forbade banks from merging with insurance underwriters. Citigroup was granted two to five years to divest itself of any prohibited corporate assets unless permissible laws were passed such as the *FSMA*.

[19] A key assumption was that centralized management functions would produce synergistic cost efficiencies with the elimination of overlapping and competing firm embedded bureaucracies. This corporate reorganization was expected to reduce the cost of financial services to consumers and increase the return of investment to shareholders.

Senior VP of Citibank and *guru* of corporate risk management.[20] Significantly, the lofty synergy and profit expectations of the FSC's corporate model proved short-lived albeit masked by the extraordinary profits generated by their wholesale bank divisions during the 2002-07 period.

Financial Engineering: The Magic of Securitization, Innovativeness of Structured Investment Products, and Profitability of Deregulated Derivatives Trading

The next phase of banking de-regulation focused on the development of a wide range of private securitizations or structured finance securities such as Asset Backed Securities("ABS"),[21] Mortgage Backed Securities ("MBS"),[22] Collateralized Mortgage Obligations ("CMO"),[23] and Collateralized Debt Obligations ("CDOs")[24] along with related risk management and other financial derivatives such as credit default and interest rate swaps.[25] With statutory authority

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[20] Robert Rubin served as co-chairman of Goldman Sachs at the end of his 26-year tenure at the firm. In January 1993, Rubin resigned from Goldman Sachs and was appointed Director of the National Economic Council by President Bill Clinton. He was instrumental to the passage of the North American Free Trade Agreement ("NAFTA") in 1993. From 1995 to 1999, Rubin served as U.S. Secretary of Treasury. He resigned after the enactment of the *Financial Services Modernization Act of 1999* to become a senior Vice-President of Citibank (1999-2009). See William D. Cohan, "*Rethinking Robert Rubin*," Bloomberg Business, September 30, 2012[b]; Available on line at http://www.bloomberg.com/bw/articles/2012-09-19/rethinking-robert-rubin; William Cohan, Wall Street: Money and Power: How Goldman Sachs Came To Rule The World, Anchor Books, (2012[a]); and Carol J. Loomis, "*The Larger-Than-Life Life of Robert Rubin,"* FORTUNE Magazine, December 8, 2003. Available at http://archive.fortune.com/magazines/fortune/fortune_archive/2003/12/08/355123/index.htm.

[21] A debt instrument secured by assets such as residential mortgages, HELOCs, credit card loans, auto loans, or student loans. The consumer debt generated from the retail side of the bank holding company is essentially sold to its "sister" wholesale investment banks (or its network of investment banks). Typically, bundles of conforming consumer loans are packaged and secured in a legal trust (ABS) that generates a monthly cash flow stream based on consumer payments to designated servicers of these consumer loan accounts.

[22] A debt instrument secured by a pool of mortgages that can be either residential or commercial properties. The MBS market is distinguished by "conforming" mortgage loans that are based on specific underwriting criteria that are required in order to be purchased by Government-Sponsored Enterprises (GSEs) such as Fannie Mae and Freddie Mac; GSEs are created by the federal government for pursuing certain public policy goals that are designated in their charters.

[23] A type of security that is typically composed of the riskier segments or "tranches" of mortgage-backed securities. The most notorious buyers were corporate entities created by Wall Street investment banks called Special Purpose Vehicles (SPVs). They purchased corporate bonds, commercial real estate bonds, credit card, ABS, and MBS that became the underlying assets of the SPV's Collateralized Debt Obligations (CDOs).

[24] Depending upon the risk characteristics of the SPV, the CDOs were commonly leveraged by trading derivatives and even "synthetic" derivatives (without any underlying assets) along with credit default "swaps" that served as hedges or insurance against defaults on consumer payments.

[25] Derivatives are financial contracts whose prices are determined by, or "derived" from, the value of some

granted by the 1999 *FSMA* to rescind the regulatory "firewalls" between retail and wholesale bank divisions, investment banks such as Salomon Brothers (Citigroup), Morgan Stanley, and Lehman Brothers sought to exponentially increase trading revenues from these highly leveraged securities, risk mitigation derivatives (trading "hedges" or arbitrage), and highly speculative derivatives including "synthetic" derivatives and "naked" swaps.[26]

For Wall Street, with hundreds of <u>trillions</u> of dollars of derivatives trades at stake, its next legislative objective was to codify the deregulation of financial derivatives trading activities that were monitored through commodity exchange markets, especially the Commodity Futures Trading Commission ("CFTC"). Not incidentally, the rapid growth of the increasingly unregulated derivatives market in the 1990s was accompanied by a succession of significant losses, scandals, and CFTC enforcement actions that culminated in 1994 with the $1.5 billion loss of Orange County, California due to speculative positions in Over-The-Counter ("OTC") derivatives.[27] This resulted in an official investigation by the U.S. General Accountability Office ("GAO"). In its 1994 report, the GAO concluded that the unregulated OTC derivatives markets posed a serious systemic risk to the U.S. financial system.[28]

As debate over regulating OTC derivatives trading intensified in 1998, the CFTC sought

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underlying asset, rate, index, or event. They are not used for capital formation or investment such as the purchase or sale of financial securities. Rather, they are instruments for hedging business risk or for speculating on changes in economic indices such prices and interest rates. Derivatives come in many forms. The most common are Over-The-Counter (OTC) swaps and exchange-traded futures and options.

[26] A key OTC derivative that precipitated the financial crisis was the credit default swap (CDS). It offers the seller a little potential upside at the relatively small risk of a potentially large downside. The purchaser of a CDS transfers to the seller the default risk of an underlying debt. The debt security could be any bond or loan obligation. The CDS buyer makes periodic payments to the seller during the life of the swap. In return, the seller offers protection against default or specified "credit events" such as a partial default on ABS or CDO revenue streams. If a credit event such as a default occurs, the CDS seller typically pays the buyer the face value of the debt. Similarly, if an interest rate swap was purchased as a hedge against rising inflation/interest rates, the CDS seller typically pays the buyer the difference in the current market value of the security.

[27]The county filed for bankruptcy in 1994—the largest by a municipality in U.S. history. Its derivatives dealer, Merrill Lynch, paid $400 million to settle claims filed by Orange County. See Brooksley Born, chairperson, U.S. Commodity Futures Trading Commission (CFTC), *"Concerning the Over-The-Counter Derivatives Market,"* prepared testimony before the U.S. House Committee on Banking and Financial Services, 105th Cong., 2nd sess., July 24, 1998.

[28] In response to the Orange County (CA) derivatives losses, the U.S. General Accountability Office (GAO) concluded that "the sudden failure or abrupt withdrawal from trading of any one of these large dealers could cause liquidity problems in the [financial] markets and could also pose risks to the others, including federally insured banks and the financial system as a whole." See GAO, *Financial Derivatives: Actions Needed to Protect the Financial System*, GGD-94-133 (Report to Congressional Requesters), May 18, 1994, p. 3.

to reexamine and enhance its supervisory oversight following the markets' rapid evolution and increasing frequency and scale of losses since 1993. Surprisingly, this resulted in an unusual rebuke by the major U.S. federal regulators. In May 1998, a joint statement issued by U.S. Treasury Secretary Robert Rubin, SEC Chairman Arthur Levitt, and Federal Reserve Board Chairman Greenspan criticized the much more stringent supervisory proposals of the CFTC as led by its Chairperson Brooksley Born.[29] In fact, only two months later, Federal Reserve Board Chairman Allan Greenspan, declared in his U.S. Congressional testimony of July 1998 that, *"regulation of derivatives transactions that are privately negotiated by professionals is unnecessary."*[30] Only a few weeks later, in October 1998, the U.S. Congress voted to support Wall Street's request to suspend the CFTC's recommendation to increase regulatory scrutiny and enforcement of OTC derivatives trading markets.

The following year, while Congress was passing the *FSMA* in November 1999, the President's Working Group on Financial Markets released its report urging the U.S. Congress to deregulate OTC derivatives broadly and to reduce CFTC regulation of exchange-traded derivatives in support of Chairman Greenspan's recommendation for self-regulation. The following year, the U.S. Congress passed the *Commodity Futures Modernization Act of 2000* ("CFMA"). This legislation granted specific exemptions to investment banks for the trading of "nonstandard" financial derivatives.[31] The CFMA essentially deregulated the OTC derivatives market[32] by effectively eliminating oversight by both the Commodity Futures Trading

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[29] The joint statement asserted, *"We have grave concerns about this [increased regulatory] action and its possible consequences… We are very concerned about reports that the CFTC's action may increase the legal uncertainty concerning certain types of OTC derivatives."* These senior regulators proposed a moratorium on the CFTC's ability to regulate OTC derivatives. See "Joint Statement by Treasury Secretary Robert E. Rubin, Federal Reserve Board Chairman Alan Greenspan, and Securities and Exchange Commission Chairman Arthur Levitt," Treasury Department press release, May 7, 1998, p. 36.

[30] U.S. Fed Chairman Alan Greenspan, "The Regulation of OTC Derivatives," prepared testimony before the House Committee on Banking and Financial Services, 105th Cong., 2nd sess., July 24, 1998, p. 37.

[31]The SEC retained antifraud authority over securities-based OTC derivatives such as stock options. See Commodity Futures Trading Commission, "Exemption for Certain Swap Agreements," Final Rule, Federal Registrar 58 (January 22, 1993): 5587.

[32] The derivatives markets are organized as exchanges or as over-the-counter (OTC) markets, although some recent electronic trading facilities blur the distinctions. The oldest U.S. exchange is the Chicago Board of Trade that was founded in 1848. In 1974, the U.S. Congress amended the Commodity Exchange Act of 1936 by requiring that all futures and options contracts on virtually all commodities, including financial instruments, be traded on a regulated exchange. It also created a new federal independent agency, the Commodity Futures Trading Commission (CFTC), for regulating and supervising the market. With the rapid growth of "non-standardized" OTC derivatives in the

Commission and the Security Exchange Commission ("SEC") over derivatives such as credit default swaps (CDS) and even the most speculative derivatives such as "naked" CDSs.[33] Additionally, the use of derivatives as risk mitigation strategies were ruled to be outside the regulatory purview of State Insurance regulators with immense financial advantages to investment banks.[34] At the end of 2000, when the CFMA was passed, the notional amount of global OTC derivatives outstanding was $95.2 trillion with a gross market value of $3.2 trillion. When the market peaked in June 2008, during the second year of the Financial Crisis, the outstanding amount of OTC derivatives had soared more than seven-fold to a notional amount of $672.6 trillion with a gross market value of $20.3 trillion.[35]

In sum, during this second phase of banking deregulation, structured investment securities fostered the unrestrained trading of OTC derivatives without concern over the performance of the underlying assets or the need for compensatory capital (loan-loss) reserves. Indeed, the emphasis was on procuring quantity rather than quality consumer debt that could be enhanced through the tightening of consumer bankruptcy law. Significantly, when President Clinton signed the CFMA into law on December 21, 2000, he vetoed the Bankruptcy Reform Act of 2000 with a "pocket veto" a week later.

From Treasury to Citibank:
Robert Rubin's Rollercoaster Ride of Banking Deregulation and Financial Engineering

The *raison d'etre* for legalizing the conglomerate structure of FSCs such as Citigroup

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1980s, the large financial institutions acting as OTC derivatives dealers sought to be exempted from the Commodity Exchange Act's requirement that the trading of their products be conducted on a regulated exchange. In 1993, the CFTC agreed to this request for an exemption while maintaining prohibitions against fraud and manipulation.

[33]The purchaser of a CDS transfers to the seller the default risk of an underlying debt. The debt security can be any bond or loan obligation. The CDS buyer made periodic payments to the seller during the life of the swap. In return, the seller offered protection against default or specified "credit events" such as a partial default. If a credit event such as a default occurred, the CDS seller would typically pay the buyer the face value of the debt.

[34] The key issue is that CDSs do not require compensating capital reserves such as loan-loss reserves. From the perspective of investment banks, the financial engineering of consumer debt portfolios into structured finance securities offered many profit enhancing advantages including lower dependence on consumer deposits for lending, lower capital reserve requirements, new sources of off-book revenues, and collateral from securitizations that can be included in bank portfolios.

[35]Bank for International Settlements, data on semiannual OTC derivatives statistics as cited in FCIR, (2011), p. 561 (ft. 41).

was based on unrealistic organizational and marketing synergies of "one stop" consumer shopping. This corporate model featured a full range of retail financial products: insurance (Travelers), retail banking (Citibank), retail brokerage/wealth management services (Salomon Smith Barney),[36] and a variety of subprime loan products (Argent Mortgage, CitiFinancial, First Capital Corp). The key assumption was that these corporate synergies would produce a market changing "win-win" that included lower cost products/services to consumers and higher profits/returns to investors.[37] Hence, the key to the success of this initial phase of banking deregulation was the integration of a wide range of retail financial service providers rather than developing new consumer products. With rapid advances in IT processes in the late 1990s, organizational synergies were expected to be the catalyst of management efficiencies as FSCs acquired existing brands of consumer products.

For Wall Street, inflated market expectations of FSCs produced immediate economic gains for Citi execs and shareholders, even during the economic headwinds of the 1999-2001 recession. For example, Citigroup's common stock nearly doubled from $187.50 in September 1998 to $330.00 in September 1999 in anticipation of the passage of the FSMA the following month. With Citigroup lobbyists and its PR machine touting the synergies of the revolutionary FSC business model, Citi stock soared to $540.62 in September of 2000 following its $31 billion acquisition of Associates First, then the second-largest subprime lender in the country after Household Finance. This imprudent expansion into subprime lending would haunt Citi as its large subprime mortgage portfolio would be a major factor in its eventual financial insolvency.[38]

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[36] The Salomon Smith Barney institutional investment/wealth management division was sold to Morgan Stanley as an asset sale during Citi's bankruptcy restructuring in 2008. It began with Citi selling 51% of the equity of the subsequent joint venture between the companies. The business was valued at $13.5 billion in 2012 when Morgan Stanley completed the purchase of the remaining 35% equity for $4.7 billion plus $2.0 billion for redeeming Citigroup preferred securities. See Lauren Tara LaCapra, *"Morgan Stanley finishes wealth business buyout,"* Reuters, June 21, 2013. Available at https://www.reuters.com/article/us-morganstanley-smithbarney-idUSBRE95K0JB20130621

[37]See Manning, (2000), Chapter 3,

[38] In 2001, the Federal Trade Commission (FTC), which regulates independent mortgage companies' compliance with consumer protection laws, launched an investigation into Associates First's pre-merger business. The FTC found that the company had pressured borrowers to refinance into more expensive mortgages and to buy expensive mortgage insurance. In 2002, Citigroup reached a then record $215 million civil settlement with the FTC over Associates' "systematic and widespread deceptive and abusive lending practices." See *"Citigroup Settles FTC Charges against the Associates Record-Setting $215 Million for Subprime Lending Victims,"* Federal Trade Commission press release, September 19, 2002.

By end of 2001, the failed promises of banking deregulation that spawned the purportedly more efficient FSCs like Citigroup could no longer be ignored; the Travelers division was spun off through an IPO in 2002[39] and all remaining insurance-related products were sold to MetLife in 2005 for a combined cash and stock sale of $11.8 billion.[40] Ironically, as the US economy recovered from the 1999-2001 recession, Citi's stock price fell over 45% between September 2000-02. This reflected Citigroup's inability to realize the organizational efficiencies of its conglomerate structure. As a result, Citi's stock price fell steadily from $540.62 in September of 2000 to $405.00 in September 2001 and then to $296.50 in September 2002.[41] See Chart 1. Of course, FSC executives such as Robert Rubin had already been preparing for this day. Indeed, as members of the Citigroup Board of Directors, Rubin and future CEO Charles Prince[42] played a crucial role in guiding the company towards developing and marketing MBS investment products and CDO derivatives based on Citi's aggressive expansion into the subprime mortgage market.

As the U.S. economy recovered from the 1999-2001 recession, the retail divisions of money center banks such as Citibank aggressively marketed a wide range of consumer loan products including credit cards, auto loans, mortgages, HELOCs, and student loans. The enormous growth of consumer debt between 2000 and 2008 is staggering. This is reported in Chart 2.[43] For example, credit card debt rose from $639.9 to $983.3 billion (53.7%) while

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[39] Paul Beckett, *"Citigroup to Split Off Travelers Unit In an IPO Expected Early Next Year,"* The Wall Street Journal, December 20, 2001. Available at https://www.wsj.com/articles/SB1008806448398728160.

[40] Associated Press, *"MetLife and Citigroup Close Travelers Deal, Deal Creates Largest Insurance Company in Sales,"* July 1, 2005. Available at http://www.nbcnews.com/id/8430830/ns/business-us_business/t/metlife-citigroup-close-travelers-deal/#.W0VnltIzZPY.

[41] The monthly common stock price of Citibank/Citigroup during the period 1995-2015 is available at https://finance.yahoo.com/quote/C/history?period1=652136400&period2=1528664400&interval=1mo&filter=history&frequency=1mo.

[42] Prince succeeded Sandy Weill as CEO of Citigroup in 2003 and as the Chairman of the Citigroup Board of Directors in 2006. He retired from both his chairman and chief executive duties in November 2007 as a result of Citi's poor financial performance due to mounting MBS and CDO related losses. He was replaced by Vikram Pandit as the CEO of Citigroup and by Robert Rubin as its Chairman. Nevertheless, Prince's severance package totaled over $80 million. It included an exit bonus of $12.5 million plus accumulated stock options worth over $68 million and a $1.7 million pension, an office, car and driver for up to five years. During his tenure, the market value of Citigroup dropped by $64 billion. See *"Profile of Prince,"* New York Times, April 9, 2010.

[43] Consumer loan data is obtained from U.S. Federal Reserve. Available at https://www.federalreserve.gov/releases/g19/HIST/default.htm.

nonrevolving debt climbed from $964.8 billion to $1.64 trillion (70%).[44] Additionally, student loans more than tripled from nearly $200 to $626.6 billion. Of course, the major household obligation is home mortgage debt. It more than doubled from $6.46 to $14.95 trillion.[45] Overall, combined household consumer debt soared from $8.46 to $18.0 trillion. Significantly, this included an increasing proportion of high interest, "risk-based" subprime loans after 2003.[46] With the end of Glass-Stegall regulations that eliminated the statutory "firewalls" between retail and wholesale banks, this "raw" consumer debt was sold to Wall Street investment banks where it was converted into AAA grade, Asset Backed Securities (ABS) after being "evaluated" by the major bond rating agencies such as Standard and Poor's, Moody's, and Fitch. The success of this initial phase of financial engineering was followed by wholesale banking divisions of Citibank and other FSCs developing even more sophisticated and risky structured financial securities such as CDOs.

These new investment products precipitated a new generation of trillions of dollars of complex OTC derivatives trading such as CDSs, "naked" swaps, and even "synthetic" derivatives that were too complex even for government regulators to evaluate. In fact, Warren Buffett, Chairman and CEO of Berkshire Hathaway Inc., testified before the Financial Crisis Inquiry Commission (FCIC) that derivatives are "very dangerous stuff," difficult for market participants, regulators, auditors, and investors to understand. Buffett concluded that, "I don't think I could manage" a complex derivatives book.[47] The rapid growth of Citi's investment banking activities, including derivatives trading, is mirrored in the rapid ascent of its stock price: leaping from $296.50 in September 2002 to $455.10 in September 2003 followed by a slight decline to $441.20 in September 2004. Not incidentally, Citigroup's net income peaked at +$24.66 billion in 2005 yet the stock market price rose only modestly to $455.20 in September

[44] Includes loans for motor vehicles, mobile homes, boats, trailers, and vacations. These loans may be secured or unsecured.

[45]It is important to note that refinanced mortgage debt includes hundreds of billions of dollars in consumer debt including credit card, auto, and student loans plus new loan origination fees.

[46] See FCIC, Part III, pp. 83-230.

[47]Warren Buffett, testimony before the FCIC, Hearing on the *"Credibility of Credit Ratings, the Investment Decisions Made Based on Those Ratings, and the Financial Crisis,"* session 2: Credit Ratings and the Financial Crisis, June 2, 2010, transcript, pp. 312, 325-326.

2005.[48]

In 2005, Citi mortgage and other major retail banks began underwriting 'nonstandard,' 'no documents,' and 'stated income' mortgages to generate higher loan volume for the voracious "securitization machine" created by its wholesale banking division.[49] Although Citi's annual net income dropped by $3.1 billion to +$21.5 billion in 2006, its stock price rose moderately to $496.70 in September 2006. By June 2007, however, the magic of financial engineering could no longer maintain the illusion of an economic juggernaut as the consequences of sacrificing loan quality for loan volume began to impact Citi's financial bottom line. Between 2006 and 2007, Citi's net income plunged, from $21.5 billion to only to $3.6 billion. Even so, its stock price only declined to $466.70. Unfortunately for Citigroup, this marked the end of its high corporate valuation as the subprime mortgage crisis would soon precipitate its financial collapse.

According to Senior Vice-President Richard M. Bowen III, the chief underwriter of Citigroup's Consumer Lending Group and supervisor of CitiFinancial's $90 billion annual mortgage loan business, "[a] decision was made [in 2005] that 'We're going to have to hold our nose and start buying the stated [mortgage] product if we want to stay in business."[50] By June 2006, Bowen estimated that as much as 60% of the loans that CitiFinancial was buying were defective; these mortgages were sold to Fannie Mae, Freddie Mac, and other investors. This trend worsened in 2007 with over 80% of Citi mortgage loans deemed defective and an increasing proportion the result of mortgage fraud. Bowen feared that this swift decline in new loan quality would endanger the bank's economic future; if borrowers defaulted on their loans, then investors could force Citi to buy them back.[51] Not surprisingly, the New York Stock

[48] Citibank net income is obtained from annual corporate reports. They are available at http://www.annualreports.com/Company/citigroup-inc. A summary of Citibank annual net income from 2005 to present is available at https://www.statista.com/statistics/271434/net-income-or-loss-of-citigroup-since-2005/.

[49] From 2000 to 2007, low- and no-doc loans soared from less than 2% to about 9% of all outstanding mortgages. Among Alt-A mortgage securitizations, 80% of loans issued in 2006 had limited or no documentation. The mortgage industry's own fraud specialists described stated income loans as "an open 'invitation to fraud' that justified the term 'liar's loans.' See FCIC, pp. 110-111.

[50] Interview with Richard Bowen, February 27, 2010, cited in FCIC, p. 111.

[51] Interview with Richard Bowen, February 27, 2010, cited in FCIC, p. 19. Bowen's concerns resulted in a formal investigation in 2007. It confirmed a major breakdown in the internal controls of the Consumer Lending Group since 2005. Even so, Bowen's charges were ignored despite the fact that withholding such information from shareholders violated the Sarbanes–Oxley Act ("SOX"). Citigroup CEO Charles Prince subsequently certified that the bank was in compliance with SOX despite Bowen's allegations that revealed the opposite. Citigroup eventually stripped Bowen of most of his responsibilities and he subsequently became a key whistleblower against the bank.

Exchange ("NYSE") confirmed Bowen's prediction as Citi stock plunged over 50% to $205.10 in September 2008. During this period, annual net income fell precipitously from +$3.6 billion in 2007 to -27.7 billion in 2008 and then to -1.6 billion in 2009. For Robert Rubin, his ten-year rollercoaster ride at Citi abruptly ended in disgrace with the bank's historic bankruptcy.[52]

By November 2008, Citigroup was insolvent even after receiving $25 billion from the Troubled Asset Relief Program ("TARP") fund. Incredibly, in less than two years, Citi's $300 billion market capitalization in mid-2007 crashed to less than $6 billion in early 2009 while its stock price fell from $466 in September 2007 to less than $15 in February 2009.[53] As a *"Too Big To Fail"* FSC, Citi received a total bailout package of $306 billion in federal guarantees and a total cash infusion of $45 billion from various federal government programs including the U.S. Treasury, Federal Reserve, FDIC, and TARP.[54] The federal government also agreed to cover 90% of the losses on Citigroup's $335 billion consumer debt portfolio after Citigroup absorbed the first $29 billion in losses.[55] In return, the U.S. Treasury converted its $25 billion in emergency aid into common stock—a 36% equity stake—with the U.S. Treasure providing an additional $45 billion credit line to ensure the bank's solvency. This agreement was announced at the end of February 2009 with provisions that restricted senior executive compensation.[56] By

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[52] Rubin reportedly earned over $126 million during his ten-year tenure at Citibank. Ironically, Rubin was responsible for Citibank's Risk Management policies including oversight of its mortgage loan underwriting policies. See Rubin's testimony before the FCIC, Hearing on *"Subprime Lending and Securitization and Government-Sponsored Entities (GSEs),"* day 2, session 1: Citigroup Senior Management, April 8, 2010 and Cohan, (2012[b]).

[53] At its nadir, shares of Citigroup common stock traded below $1.00 on the New York Stock Exchange. In an effort to boost the trading price of Citi stock, a 1/10 reverse stock split was conducted on May 9, 2011. This raised the stock price by reducing outstanding shares. In comparison, Citi conducted several stock splits over the last 20 years that sought to reduce the trading price: 4/3 stock split on August 28, 2000, 3/2 stock split on June 1, 1999, 3/2 stock split on November 20, 1997, 4/3 stock split on November 25, 1996, and 3/2 stock split on May 28, 1996.

[54] For review of the costs of the Citigroup bailout, see Center for Public Integrity, *"Who's Behind the Financial Meltdown? No, 15 of The Subprime 25: CitiFinancial / Citigroup Inc.,"* May 19, 2014. Available at https://www.publicintegrity.org/2009/05/06/13009/no-15-subprime-25-citifinancial-citigroup-inc.

[55] The U.S Treasury agreed to assume the first $5 billion in losses, the FDIC the next $10 billion, and then the U.S. Federal Reserve would assume the rest of the risk.

[56] According to New York Attorney General Andrew Cuomo, Citigroup paid hundreds of millions of dollars in bonuses to more than 1,038 of its employees after receiving its $45 billion TARP funds in late 2008. This included 738 employees each receiving $1 million in bonuses, 176 employees each receiving $2 million bonuses, 124 each receiving $3 million in bonuses, and 143 each receiving bonuses of $4 million to more than $10 million. As a result of public criticism and the U.S. Government's majority holding of Citigroup's common shares, compensation and

December 2009, the U.S. government stake was reduced from 36% to a 27%, after Citigroup sold $21 billion of common shares and equity in the largest single share sale in U.S. history. By December 2010, after Citigroup's return to profitability, it repaid the emergency aid in full which rescinded government restrictions on pay and oversight of the senior management. With the sale of its remaining 27% equity stake, the U.S. government realized a $12 billion profit.[57]

Today, nearly 10 years later, Citi trades at under $70 per share. Although Citi's annual net income has increased steadily—peaking at $17.2 billion in 2015--it is still paying off its mountain of outstanding legacy lawsuits, financial settlements, and other financial obligations arising from the Financial Crisis of 2007-09. Not surprisingly, Robert Rubin and other FSC executives have faced potential criminal charges from US government regulators as well as private class-action shareholder lawsuits.[58] So far, not a single U.S. FSC senior executive has been convicted of a criminal charge related to their role in the Financial Crisis of 2007-09.[59] Unfortunately for many Citi clients, who have suffered severe personal hardships from the FSC's role in enacting BAPCPA and precipitating the Financial Crisis, their experience with the bankruptcy court has been much less supportive of the "fresh start" granted to Citigroup and its

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bonuses were restricted from February 2009 until December 2010. See Stephen Grocer, *"Wall Street Compensation–'No Clear Rhyme or Reason,"* The Wall Street Journal, July 30, 2009.

[57] David Lawder, *"U.S. exits Citigroup stake and earns $12 billion profit,"* Reuters, December 7, 2010.

[58] The shareholder suit against Robert Rubin and other senior executives alleged that the plaintiffs sold over $150 million of their own shares of Citibank stock at inflated prices while concealing the precarious financial condition of the company. See Graybow, (2008). Furthermore, as the Financial Crisis Inquiry Commission ("FCIC") was completing its investigation in late 2010, it *"alleged that Rubin and other senior Citibank executives were 'culpable' for misleading Citi's investors and the [financial] market by hiding the extent of the bank's subprime exposure, stating at one point that it was [only $13 billion or] 76% lower than it actually was [$55 billion]."* The FCIC staff reported that these misrepresentations by Citibank CEO Charles Prince and Rubin occurred during an October 15, 2007 analysts call and thus appeared to have violated SEC Rule 10b-5. The FCIC voted unanimously to refer Rubin and Prince for further investigation by the DOJ. See Stephen Gandel, (2006), "*Robert Rubin Was Targeted for DOJ Investigation by Financial Crisis Commission,"* FORTUNE Magazine, March 13, 2016. Available at http://fortune.com/2016/03/13/robert-rubin-financial-crisis-commission-justice-department/

[59] In comparison, Icelandic bank regulators have been the most aggressive in successfully prosecuting and convicting six senior bank executives for fraud and market manipulation. See Michael J. de la Merced, "*The Small Club of Bank Executives Charged With Crisis-Era Crimes Just Got Bigger,"* *The New York Times*, June 21, 2018. Available at https://www.nytimes.com/2018/06/21/business/dealbook/anglo-irish-bank-financial-crisis.html?emc=edit_dk_20180622&nl=dealbook&nlid=5762042820180622&te=1

corporate executives.

U.S. Bankruptcy Reform: Tightening the Administrative Vise for 'Fresh Starts'

The third component of Wall Street's legislative campaign was the enactment of bankruptcy reform. The banking industry sought to codify procedural impediments that restricted and/or delayed Chapter 7 discharge of unsecured debts.[60] This was accomplished by creating a more costly and laborious bankruptcy process that requires: (1) a pre-petition counseling session from a U.S. Department of Justice ("DOJ") approved nonprofit consumer credit counseling organization[61] and (2) a crude income "means-test" that more rigorously screened the eligibility of above median income petitioners for Chapter 7 discharge relief.[62] Indeed, what is striking about the legislative debate over BAPCPA is the enormous disjuncture between the inflated recovery estimates of bank industry representatives and their allies of $40 to $55 billion per year in late 1990s and the modest estimates of objective government analysts and prominent bankruptcy academics.[63] Net of higher bankruptcy filing fees and legal expenses, BAPCPA is generously estimated to yield less than $1 billion per year (more accurate estimate is about net $600 - $800 million) in additional recoveries in the early 2000s and even less today.[64]

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[60]BAPCPA not only increases the difficulty in obtaining a "Fresh Start" today, but it delays future discharges by extending the period between Chapter 7 filings. Specifically, BAPCPA increased the waiting period from six years under the Pre-BAPCPA statute to eight years under 11 U.S.C. § 727(a)(8)(2006).

[61] Lois R. Lupica. *The Consumer Bankruptcy Fee Study Final Report*, ABI and NCBJ, (2011); Karen Gross and Susan Block-Lieb, "*Empty Mandate or Opportunity for Innovation? Pre-Petition Credit Counseling and Post-Petition Financial Management Education,"* 13 American Bankruptcy Institute Law Review, 549 (2005); Jean Braucher, "*An Empirical Study of Debtor Education in Bankruptcy: Impact on Chapter 13 Completion Not Shown,"* American Bankruptcy Institute Law Review, (Winter 2001); and Howard Hoffman, "*Consumer Bankruptcy Filers and Pre-Petition Consumer Credit Counseling: Is Congress Trying to Place the Fox in Charge of the Henhouse?"* Business Law Journal, Vol. 54, (1999): 1629-1640.

[62] The espoused intent of the means test is to more rigorously screen "can-pay" petitioners with above median income in their state of residence. Based on a formulistic assessment of their allowable expenses, debtors with above median income that can make payments of at least $25 per week ($6,000 over 5 years) are required to file Chapter 13 re-organization payment plans or have their bankruptcy petitions rejected. See 11 U.S.C. §§ 109(e), 707(b) (2006).

[63] These net recovery estimates are based on approximately 1.4 million annual filers.

[64] See Robert D. Manning, "*The Debate over Personal Versus Institutional Responsibility: Transforming the Narrative of the Worthy Debtor,"* (February 2018) for a detailed discussion of these dramatically different recovery estimates of means-tested filers immediately following the enactment of BAPCPA in 2005.

At first glance, this paltry economic gain does not seem to justify the enormous expenditure of financial resources and political capital that was necessary to enact BAPCPA. Unless bankruptcy reform legislation is examined in the larger context of *Financialization* and banking de-regulation of the late1990s, the misplaced focus on the modest increase in debtor payments deflects attention from the fundamental role that BAPCPA played in Wall Street's financial engineering strategies of the early 2000s. That is, BAPCPA helped to reduce the volatility of trillions of dollars of ABS and CDO securitized trusts that contributed to hundreds of trillions of dollars in notional derivatives trades in the 2000s. In contrast, the traditional "sweatbox" examination of BAPCPA's impact on 'fresh start' discharge filers[65] focuses on refuting the CFSs' rhetorical assertions regarding the decline in personal responsibility and widespread fraudulent abuse of the bankruptcy system.[66]

In sum, from the perspective of banking de-regulation, BAPCPA played a much more important role as a small cog in the process of converting subprime consumer debt into AAA grade, ABS securities prior to the Financial Crisis of 2007-09. In the process, BAPCPA served two very important functions for Wall Street. First, it re-framed the political and legal discourse over the social role of personal bankruptcy. That is, it shifted the focus of the bankruptcy court from guaranteeing legal protection for financially distressed borrowers whose "last resort" petition followed "unfortunate" circumstances ("fresh start") to an administrative gatekeeper function for punishing irresponsible and overindulgent filers—the *"Unworthy Debtor."*

Second, BAPCPA indirectly enhanced the value of ABS investments by enforcing a crude means-test as mandated by the U.S. Congress through Bankruptcy Court. Although the

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[65] See Katherine M. Porter, *"The Pretend Solution: An Empirical Study of Bankruptcy Outcomes,"* Texas Law Review, Vol. 90, (2011); Robert M. Lawless, et al, *"Did Bankruptcy Reform Fail? An Empirical Study of Consumer Debtors,"* American Bankruptcy Law Journal, Vol. 82, (2008); Ronald J. Mann, *"Consumer Bankruptcy and Credit in the Wake of the 2005 Act: Bankruptcy Reform and the "Sweat Box" of Credit Card Debt,"* University of Illinois Law Review, (2007); Scott F. Norberg, *"The Chapter 13 Project: Little Paid to Unsecureds,"* American Bankruptcy Institute Law Journal, Vol. 26, 1, (2007):54-56; Scott F. Norberg and Andrew J. Velkey. *"Debtor Discharge and Creditor Repayment in Chapter 13,"* Creighton Law Review, Vol. 39, (2006); Marianne Culhane and Michaela White, *"Taking the New Consumer Bankruptcy Model for a Test Drove: Means Testing Real Chapter 7 Debtors,"* American Bankruptcy Institute Law Journal, Vol. 27, (1999); and Marianne Culhane and Michaela M. White, *"Debt After Discharge: An Empirical study of Reaffirmation,"* American Bankruptcy Law Journal, Vol. 73, (1999).

[66] See Jones, Judge Edith H. and Todd J. Zywicki, "*It's Time For Means Testing*," Brigham Young University Law Review, Vol. 1, (1999):177-252.

explicit goal of this BAPCPA provision is to increase "deadbeat" debtor payments to creditors based on filers' future earnings (3 to 5 year Chapter 13 reorganization plans), the modest increase (much less than $1 billion per year) before the 2007-09 Crisis belies its more important purpose for Wall Street. That is, by discouraging and ultimately delaying consumer bankruptcy discharges,[67] BAPCPA helped to stabilize the securitized trusts of pooled consumer debt that constitute the underlying asset value of highly leveraged, structured investment products. For investment banks, the lower volatility of "pooled" consumer debt in securitized ABS, MBS, and CDO trusts expanded the amount of consumer debt available for creating structured investment products, enhanced yields of securitized trusts with lower management costs,[68] increased investor confidence, and contributed to the exponential growth of trading revenues on Wall Street until the inevitable collapse of the derivatives market in mid-2008.[69]

A review of pre- and post-BAPCPA Chapter 7 bankruptcy filings is suggestive of the expected impact of bank influenced bankruptcy reform. See Chart 3. Between 1997 and 2000, the proportion of Chapter 7 "fresh start" discharges averaged 68.1%. During the period after the Bankruptcy reform bill was vetoed by President Clinton and then signed into law by President Bush (2001-2005), Chapter 7 filings averaged 69.7%--a modest increase in debtor discharge rates. After the enactment of BAPCPA and before the collapse of the ABS securities market in

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[67]Empirical analyses of post-BAPCPA petitions confirm that it has delayed and discouraged Chapter 7 filings. It also confirms that it has not increased Chapter 13 petitions from higher income households and thus is yielding only marginal increases in debtor payments to unsecured creditors. See Katherine M. Porter, "*The Pretend Solution: An Empirical Study of Bankruptcy Outcomes,"* 90 Texas Law Review, 103 (2011); Robert M. Lawless, Angela K. Littwin, Katherine M. Porter, John A. E. Pottow, Deborah Thorne, and Elizabeth Warren. *"Did Bankruptcy Reform Fail? An Empirical Study of Consumer Debtors,"* American Bankruptcy Law Journal, Vol. 82, (2008): 349-406; Mann, (2007); Scott F. Norberg, "*The Chapter 13 Project: Little Paid to Unsecureds,"* 26 American Bankruptcy Institute Law Journal, 1, 54–56 (2007); Bruce M. Price and Terry Dalton, "*From Downhill to Slalom: An Empirical Analysis of the Effectiveness of BAPCPA (and Some Unintended Consequences),"* 26 Yale Law & Policy Review, 135, 193–94 (2007); Scott F. Norberg and Andrew J. Velkey, "*Debtor Discharge and Creditor Repayment in Chapter 13,"* 39 Creighton Law Review, 473 (2006).

[68]The discharge of individual consumer debts by the bankruptcy court may require replacement with new performing consumer debts in order to stabilize the revenue streams generated by the securitized trust that underlies the specific ABS. A lower discharge rate entails less costs for managing the securitized trust and more available consumer debt to "bundle" into new ABS to be sold to investors. Once default rates on consumer debt began rising while the volume of new consumer debt began shrinking in 2006, investment banks were unable to replenish and stabilize ABS revenue streams as retail banks faced an internal liquidity crisis. This led to a domino effect in defaults of CDO tranches and a rapid decline in value and demand for ABS securities by mid-2008. See FCIR, (2011).

[69] It is important to note that the long-term calculus for Wall Street investment decisions rarely exceed three months (Quarterly Reports).

mid-2008, however, the average proportion of Chapter 7 filings fell sharply to 58.5%. This offers a crude empirical simulation of the intended effect of the Bankruptcy Reform Act of 2000. If the lower post-BAPCPA rate of Chapter 7 filings is replaced with the prevailing rate in the 2001-05 period, then the number of Chapter 7 filings may have fallen by approximately 1.1 million during this five year period—replaced by an increased number of Chapter 13 reorganization plans or postponed filings.[70] And, assuming that the average number of discharged consumer accounts was about 6 per consumer filer during this period,[71] then bankruptcy reform could have potentially delayed the withdrawal of nearly 6 million personal accounts from securitized consumer debt trusts between 2001 and 2005.

Furthermore, Robert Lawless et al (2008) assert that several hundred thousand bankruptcy eligible debtors did not file in each of the years immediately after the enactment of BAPCPA for a variety of reasons including higher filing fees and concerns over more stringent means-test requirements. If a conservative estimate of bankruptcy eligible nonfilers that "disappeared" after the enactment of BAPCPA is included, as many as another one-half million debtors (100,000 per year) with at least six consumer accounts may not have been withdrawn from ABS securitized trusts during this five-year period (2001-05). Hence, if BAPCPA had been enacted in 2000 instead of 2005, it may have potentially delayed the withdrawal of nearly 9 million consumer accounts prior to the collapse of the ABS market in 2008.[72] This would have reduced the volatility of pooled consumer debt trusts AND increased the size of the ABS market with the creation of a greater volume of new securities. Also, the higher volume of ABS would have resulted in a trillions of dollars of additional derivatives trades.

[70] Based on the average Chapter 7 filing rate of 58.5% during this post-BAPCPA period (2006-mid-2008), the estimated reduction in Chapter 7 filings that would have replaced Chapter 13 filings by year is: 158,342 (2001), 163,533 (2002), 183,837 (2003), 182,788 (2004), and 412,876 (2005). Hence, the total estimated increase in Chapter 13 filings during this five-year period would have been 1,101,376. See Chart 2 for the actual consumer bankruptcy filing rates by Chapter 7 and Chapter 13 during this period.

[71] See Porter (2011) and Lawless et al (2008).

[72] This number is dependent on the proportion of consumer debt accounts that were included in ABS and CDO structured investment products. Not incidentally, the discharge of unsecured debts by Chapter 7 filers may have saved hundreds of thousands of homes of those families who were employed and could pay their mortgages after their "fresh start." Hence, Chapter 7 filings reduced the volatility of MBS while it increased the volatility of ABS and CDOs whose underlying assets were nonmortgage, unsecured debts.

The 'Modernization' of the Nonprofit Debt Management Industry: Closing the Loop of Consumer Collections Industry

A related and parallel objective of the Financial Services industry was the creation of a national, "third-party" consumer debt collections system. This is due to the enormous growth of unsecured consumer loans in the 1990s. Today, over 77 million Americans have at least one financial account in collections.[73] From the banks' perspective, the financially independent, nonprofit debt management sector threatened its control over the consumer debt collection industry. The key was the development of a "Good/Bad Cop" system of consumer debt collections. This entailed a coordinated strategy of coopting and subsequently transforming the nonprofit credit counseling industry from local *social service* oriented Consumer Credit Counseling Services ("CCCS") organizations to national *revenue maximizing* Consumer Counseling Agencies ("CCA") corporations. The latter essentially operated as for-profit corporations through a *hybrid structure* that featured for-profit and not-for-profit "sister" companies through the late 2000s.[74] That is, the main role of nonprofit revenue maximizing CCAs is to market and process consumer Debt Management Plans ("DMP") as cost-efficiently as possible for the economic benefit of their founders/senior executives[75] in their role of reducing the credit card collection costs of major banks.[76]

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[73]Jimenez (2015); Ratcliffe et. al. (2014); and FTC (2013).

[74]See Fred O. Williams, *Behind the Credit Curtain,* CreditCards.com, February 11, 2013. Available at http://www.foxbusiness.com/personal-finance/2013/02/04/behind-credit-counseling-curtain/. See also: Anita C. Butera and Robert D. Manning, *A Failing Grade for the Post-BAPCPA Credit Counseling and Bankruptcy Education Industry?,* IHELG RESEARCH MONOGRAPH SERIES, University of Houston Law School, June 2015. Available on line at https://www.law.uh.edu/ihelg/monograph/15-08.pdf

[75]For example, the CEO of nonprofit Money Management International ("MMI"), Ivan Hand, received about $1.5 million in 2014. Hand's compensation exceeded the total compensation of Harvard University's President Drew Gilpin Faust ($1.1 million) and the Red Cross's President, Gail McGovern ($600,000 package). See Fred O. Williams, *Salaries of CEOs at nonprofit credit counseling agencies, As industry shrinks, executives pull in six- and seven-figure paychecks*, CreditCards.com, April 6 2016. Available at https://www.creditcards.com/credit-card-news/salaries-ceo-nonprofit-credit-counseling-executives.php.

[76] At the height of the local CCCS network, credit card companies reduced finance charges (often to zero), waived accrued penalty fees, occasionally reduced principal balances, and paid as much as 15% "fair-share" management fee to CCCS. Today, banks have much more onerous terms for consumers that enroll in DMPs. Household budgets include lower expenditures for basic needs such as food, interest rates can rise to usurious rates following a single late payment, no debt forgiveness, and a new compensation system for CCAs that can pay as little as 2-3% of enrolled credit card debt and even zero. See Butera and Manning, (2015).

The integration of the nonprofit credit counseling industry as the "Good Cop" in the debt collections arsenal of the Financial Services industry complemented the rapid expansion of its capricious and litigious army of private "Bad cops." Today, as the "soft arm" of credit card collection departments, the "modern" nonprofit DPM system features multiple conflicts of interest with more stringent full-payment plans.[77] Not incidentally, some "hardship" DMP programs offered in the late 2000s were implicitly designed to delay the inevitable bankruptcy of the most financially distressed households.[78]

Therefore, BAPCPA serves an important role in the *Financialization* of American society through its direct and indirect impact on millions of debtors in America. Specifically, BACPA has codified the shift in the political and legal discourse from assisting "unfortunate" debtors to identifying "worthy" debtors who have not exploited the consumer insolvency laws. Indeed, the judicial role of the consumer bankruptcy court has increasingly assumed an administrative "gatekeeper" role that punishes overindulgent and undisciplined deadbeat filers who "abuse" the system. In the process, BAPCPA contributed to Wall Street's key objective of increasing the stability and yields of ABS securitized trusts that generated billions of dollars in new trading revenues from highly complex financial derivatives and swaps. This was achieved by (1)

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[77]According to empirical research on DMP completion rates, the greatest likelihood of enrolling and/or completing a nonprofit DMP is the size of the interest rate concession offered by credit card companies. See Daniel Brown,, Charles Link and Michael Staten, *"The Success and Failure of Counseling Agency Debt Repayment Plans*," Eastern Economic Journal, *Vol. 38, 2012: 99-117.* Also, see Williams, (2013); *Lea Krivinskas Shepard, "'Don't File!': Rehabilitating Unauthorized Practice of Law-Based Policies in the Credit Counseling Industry,"* American Bankruptcy Law Journal, Vol. 79, (2005):51-77; John Hurst, "*Protecting Consumers From Consumer Credit Counseling,"* North Carolina Banking Institute Journal, Vol, 9, Vol. 1, (2005): 159-178; U.S. Senate, *Profiteering In A Nonprofit Industry: Abusive Practices in Credit Counseling*, Hearing before the Permanent Subcommittee on Governmental Affairs, March 24, 2004, U.S. Government Printing Office: Washington, D.C., (2005). Available at http://www.gpo.gov/fdsys/pkg/CHRG-108shrg93477/pdf/CHRG-108shrg93477.pdf; U.S. Congress, Non-Profit Credit Counseling Organizations, Hearing before the House Subcommittee on Oversight of the Committee on Ways and Means, 108th Congress, U.S. Government Printing Office: Washington, D.C., 2003. Available at http://babel.hathitrust.org/cgi/pt?id=mdp.39015090387989;view=1up;seq=1; Consumer Federation of America (CFA) and National Consumer Law Center (NCLC), *Credit Counseling In Crisis: The Impact On Consumers of Funding Cuts, Higher Fees and Aggressive New Market Entrants,* Washington, DC, 2003; David A. Lander, "*Recent Developments in Consumer Debt Counseling Agencies: The Need for Reform,"* American Bankruptcy Institute Law Journal, February (2002); Stephen Gardner, "*Consumer Credit Counseling Services: The Need for Reform and Some Proposals for Change,"* Advancing The Consumer Interest, Vol. 13, (Fall 2001/Winter 2002); and David Lander, "*Developments Imperil Those Debt Counseling Agencies That Provide Effective Education and Counseling,"* 4 Norton Banker Law Adviser, 7, (2001).

[78] See Butera and Manning, (2015).

discouraging and delaying consumer bankruptcy petitions, (2) shifting as many debtor filings as possible from Chapter 7 discharges to Chapter 13 payment plans, and (3) directing financially distressed households to enroll in Debt Management Plans through the coopted system of nonprofit Consumer Counseling Agencies.

Even today, after the Financial Crisis of 2007-09, the main impact of BAPCPA has been the postponement of millions of Chapter 7 "fresh start" filings. A decade later, these trends are even more salient. As shown in Chart 3, consumer bankruptcy filings have fallen sharply--from 1.4 million in 2011 to 789,000 in 2017. Furthermore, the proportion of Chapter 7 filings has declined from 67.8% in 2011 to 59.8% in 2017.[79] These trends underscore a sharp shift from the well-established principle that the Constitution *"gives to the honest but unfortunate debtor…a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt."*[80]

Conclusion:
U.S. Bankruptcy Reform in the Era of *Financialization*

This article examines the *Bankruptcy Abuse Prevention and Consumer Protection Act* (BAPCPA) of 2005 in the larger context of *Financialization* of U.S. society. From this perspective, it begins by reviewing the ambitious legislative campaign of Wall Street during the 1990s and early 2000s. Starting with the steady erosion of bank branching restrictions in the 1980s that culminated with the *Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994*, Wall Street precipitated the massive consolidation of the banking industry that spawned the ascendance of national money center banks such as Citbank, Bank of America, and Wells Fargo. This was followed by the enactment of the *Financial Services Modernization Act* (FSMA) of 1999 that rescinded the statutory prohibitions of the *Glass-Steagall Act of 1933.* That is, by allowing the merger of Travelers Group with Citibank, it paved the way for Financial

[79] The growth of consumer bankruptcy rates tends to lag the general underwriting trends of retail financial institutions. That is, lower filings reflect more stringent bank standards. Statistically, this results in an increased proportion of higher income debtor households with greater assets that typically enroll in Chapter 13 payment plans. This suggests that the current cycle of reducing regulation of retail banks will result in less stringent underwriting standards, higher bankruptcy rates, and greater proportion of Chapter 7 filers in the near future.

[80] See: Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934). See also: Karen Gross, *Preserving a Fresh Start for the Individual Debtor: The Case of Narrow Construction of the Consumer Credit Amendment*, University of Pennsylvania Law Review, Vol. 135 (1986):59.

Services Conglomerates (FSCs) to acquire nonbank financial services companies as well as for retail banks to transact business with "sister" wholesale investment banks. This opened the door for financially engineered, structured investment products that were derived from securitized "pools" of consumer debt that were sold as ABS and CDOs to institutional investors.

The second key legislation was the Commodity Futures Modernization Act (CFMA) of 2000. This law essentially deregulated the OTC derivatives market by effectively eliminating supervisory oversight by the Commodity Futures Trading Commission and the Security Exchange Commission. These include credit default swaps, "naked" swaps, and even "synthetic" derivatives. For the investment banks of FSCs, this opened the floodgates of highly speculative derivatives trading. Between the end of 2000 and mid-2008, the notional amount of global OTC derivatives outstanding soared from $95.2 trillion ($3.2 trillion gross market value) to $672.6 trillion ($20.3 trillion gross market value). This resulting growth in derivatives trading revenues was based on the rapid expansion of securitized consumer debts that were the underlying assets of ABS and CDOs. This intensified pressure on retail banks to rapidly expand retail lending—especially subprime loans. President Clinton signed this legislative bill into law in December 2000.

The third pillar of this legislative campaign was the *Bankruptcy Reform Act* of *2000.* It was passed by the U.S. Congress in December 2000 but, unlike the CFMA, it was vetoed by President Clinton. As one of the most lobbied and debated bills of the early 2000s, the *Bankruptcy Abuse Prevention and Consumer Protection Act of 2005* was passed by the U.S. Congress and finally signed into law by President George Bush in Spring 2005. During public and legislative debate, BAPCPA played a crucial role in reshaping the political discourse and public narrative on consumer bankruptcy. That is, from a Constitutionally protected right of a financial "fresh start" for unfortunate debtors--regardless of household income--to redefining the "worthy" debtor through a crude "ability-to-pay" means test. Based on this narrative, BAPCPA deflected public attention from the widespread irresponsible and often illegal behavior of lenders while focusing on a very small percentage of debtors that exploit the bankruptcy system.

In the process, BAPCPA transformed the judicial role of the Bankruptcy Court from facilitating the fresh start of unfortunate debtors to an administrative function that screens and enforces debtor payments. These new punitive policies primarily serve the financial interests of Wall Street by delaying and discouraging the filing of Chapter 7 discharge petitions; the modest increase in Chapter 13 payments are a secondary factor. This is because the primary objective was to reduce the compositional volatility of securitized trusts of consumer debt receivables. The latter constituted the underlying value of trillions of dollars of ABS and CDOs as well as highly leveraged derivatives, swaps, and futures.

In addition, the parallel strategy of coopting and subsequently transforming the nonprofit consumer credit counseling industry in the late 1990s and 2000s contributed to the banks' objective of increasing the performance of unsecured consumer loan portfolios, especially credit card receivables. The inclusion of the nonprofit credit counseling industry as the "good cop" in its debt collections arsenal complemented the expansion of its capricious and litigious army of private "bad cops." Today, as the 'soft arm' of credit card collection departments, the "modern" nonprofit DPM system features multiple conflicts of interest while offering more stringent full-payment plans and delivering lower operational costs for banks. This includes the creation of some "hardship" DMP programs that are implicitly designed to delay the inevitable bankruptcy of the most financially distressed households.[81]

The Financial Crisis of 2007-09 resulted in the dispersal of tens of billions of dollars in federal bank bail-out funds to insolvent financial institutions, the absorption of hundreds of billions of dollars in "toxic" bank assets, and the allocation of trillions of dollars in financial guarantees plus hundreds of billions of dollars in federal stimulus programs to first stabilize and then accelerate the U.S. economic recovery. During the late 2000s, this economic calamity shifted the public focus from the irresponsible behavior of debtors to the irresponsible behavior FSCs. As the political pendulum swung sharply toward greater regulation of the Financial Services industry in the late 1990s, the enactment of the CARD Act of 2009 was swiftly followed by the Dodd-Frank Act of 2010 which included the establishment of the Consumer Financial Protection Bureau (CFPB).

Even so, the academic and political debates over BACPCA have neglected its relationship to the *Financialization* of American society. This includes the ideologically shaped narrative of the "unfortunate" or "worthy" debtor. In the case of Citibank, the documented

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[81]At the height of the local CCCS network, credit card companies reduced finance charges (often to zero), waived accrued penalty fees, occasionally reduced principal balances, and paid as much as 15% "fair-share" management fee to CCCS. Today, banks have more onerous terms on consumers enrolled in DMPs. Budgets are much lower, interest rates can rise to usurious delinquency rates, no debt forgiveness, and new compensation system that can pay as low as 2-3 enrolled and even zero. See Butera and Manning, (2015).

culpability of its senior executives in the Financial Crisis of 2007-09 did not impede the multi-billion dollar public bail-out that ensured its 'fresh start' and current profitability for its shareholders. Nor did it require senior executives to relinquish hundreds of millions of dollars in past compensation due to fraudulent corporate reporting and noncompliant lending policies. In sharp contrast to insolvent consumers, the legacy of Wall Street's self-regulated malfeasance continues as millions of Americans have been deprived of their Constitutional right to a financial "fresh start" since the enactment of BAPCPA. Unfortunately, due to the current political agenda of the U.S. Congress, it unlikely that this inequity between consumer and corporate bankruptcy filers will be addressed in the near future.