Keynote Address

The Financial Crisis and Credit Unavailability: Cause or Effect?¹

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Was the 2007-2008 global financial crisis (the “financial crisis”) the cause of credit unavailability, or was it the effect? The standard story is that the financial crisis resulted in the loss of credit availability.³ I will argue

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today that story is reversed. I will also examine what lessons that can teach us.

I. CAUSE AND EFFECT

To best assess cause and effect, consider the timeline of events leading to the financial crisis. As home prices steadily increased in the new century, it became common for lenders to make mortgage loans to even risky, or “subprime,” borrowers. This lending followed a time-tested credit-card model, in which credit is made easily available and high interest rates are charged in order to statistically offset losses. The subprime mortgage-lending was even regarded by some as more conservative than the credit-card model because mortgage lenders have not only one way out—cash flow—but also a second way out—collateral; and expected home appreciation meant that collateral values would increase and borrowers would also be able to repay through refinancing.

This model worked well so long as home prices continued to rise. The model was also consistent with the U.S. government’s strong encouragement of lenders to make mortgage loans to low-income—and often “disproportionately minority”—borrowers. Sometimes the subprime mortgage-lending occurred without full documentation of borrower income, recognizing, at least implicitly, that many seemingly low-income borrowers are actually paid on a cash basis, without officially declaring their income.

https://www.imf.org/external/pubs/ft/wp/2010/wp1047.pdf (stating that “the crisis was unprecedented in its global scale and severity, hindering credit access to businesses, households and banks”).
To that extent, not completely unlike the argument by renowned Peruvian economist Hernando de Soto that de facto property rights should be recognized in order to enable the poor to borrow and acquire capital, the model allowed de facto income to be recognized to enable the poor to borrow money and acquire homes.

But when home prices began declining, these subprime borrowers could not refinance; and in many cases, they defaulted. Even borrowers who could afford to pay their mortgage loans were tempted to walk away as mortgage loans exceeded home values. These mortgage defaults in turn caused substantial amounts of low investment-grade mortgage-backed securities to default and some AAA-rated securities to be downgraded. The defaults were especially large for certain highly leveraged securities, which were indirectly backed by subprime mortgages; full payment of even the senior classes of these securities was extremely sensitive to cash-flow variations and dependent on the (failed) assumption that housing prices would continue to appreciate.

These defaults and downgradings of rated securities, in turn, spooked investors who believed that AAA meant ironclad safety and that investment grade meant relative freedom from default. Investors started losing confidence in ratings and avoiding debt securities. Fewer investors meant

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5 For a description of credit ratings and rating agencies, see infra Part II.C.1.
6 These were called “ABS CDO” securities.
7 Steven L. Schwarcz, Keynote Address: Understanding the Subprime Financial Crisis, 60 SOUTH CAROLINA LAW REVIEW 549 (2009); also available at http://ssrn.com/abstract_id=1288687.
that the price of debt securities started falling. Falling prices meant that firms using debt securities as collateral had to mark them to market and put up cash—requiring the sale of more securities—which caused market prices to plummet further downward in a death spiral. The market prices of mortgage-backed securities, for example, collapsed substantially below the intrinsic value of the mortgage-loan assets underlying those securities.

This collapse in market prices meant that banks and other financial institutions holding mortgage-backed (and other asset-backed) securities had to write down the securities’ value. That caused institutions holding lots of these securities—epitomized by Lehman Brothers—to appear more financially risky, in turn triggering concern over counterparty risk. Afraid these institutions might default on their contractual obligations, many parties stopped dealing with them.

The refusal of the U.S. government to save Lehman Brothers in mid-September 2008, and its resulting bankruptcy, added to the panic. Debt markets became so spooked that even the short-term commercial paper markets virtually shut down. Without debt-market financing, which constitutes approximately 58% of all corporate credit availability, 

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8 For a discussion of marking to market, see infra notes 51-57 and accompanying text.
9 The high leverage of many firms appears to have made this death spiral worse. Encouraged by the earlier liquidity glut, many firms had borrowed excessively because the cost of funds was so cheap.
10 Counterparty risk refers to the risk that a party obligated on a contract may default paying another party to the contract.
companies lacked money to expand and sometimes even to pay current expenses.\textsuperscript{12} The economy collapsed.

In short, although the relationship between credit availability and financial decline leading to the crisis was somewhat interactive, a loss of credit availability appears to have caused the financial crisis more than the reverse.\textsuperscript{13} If that non-standard story is true, what lessons can it teach us?

\section*{II. Lessons}

I believe there are at least three lessons, all focused on protecting credit availability: because credit availability is dependent on financial markets as well as banks, regulation should be designed to protect the viability of markets as well as banks; more diversified sources of credit availability might increase financial stability; and regulators should try to identify and correct system-wide flaws in making credit available.

\subsection*{A. Markets as well as Banks Should be Protected}

\footnotesize{\textsuperscript{12} See, e.g., Fiorella De Fiore & Harald Uhlig, \textit{Corporate Debt Structure and the Financial Crisis}, at 2, \url{https://economicdynamics.org/meetpapers/2012/paper_429.pdf} (“the implication of the turmoil for economic activity [during the financial crisis] was a drop in investment and output that was unprecedented”).}  
\footnotesize{\textsuperscript{13} This conclusion appears to be consistent with Hayek’s monetary theory that a contraction in bank lending results in declining economic output, unemployment, and a recession or even depression. See David Bholat, \textit{Money, Bank Debt, and Business Cycles: Between Economic Development and Financial Crises}, in \textit{Availability of Credit and Secured Transactions in a Time of Crisis}, \textit{supra} note 3, at 28 (discussing Hayek’s monetary theory).}
In our market-intermediated financial system where, at least in the United States, companies today obtain much of their financing directly through capital markets, credit availability is dependent on financial markets as well as banks. Therefore regulation should be designed to protect the viability of markets as well as banks. Consider how that could be done.

Government central banks traditionally have used liquidity, such as making emergency loans, to help prevent banks in their country from defaulting. The Federal Reserve, for example, has had this role of lender of last resort to U.S. banks—although, perversely, the Dodd-Frank Act limited the Fed’s power to engage in this role. The European Central Bank has helped to recapitalize European banks exposed to sovereign-debt risk.

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14 See supra notes 11-12 and accompanying text.
15 The efforts being made to protect bank viability are beyond the scope of my Address. As a brief summary, though, in the aftermath of the financial crisis the Basel Committee on Banking Supervision adopted new capital-adequacy rules to better absorb and spread the effects of losses by banks. FEDERAL DEPOSIT INSURANCE CORPORATION, RISK MANAGEMENT MANUAL OF EXAMINATION POLICIES § 2.1-2 (2015). Similarly, post-crisis regulation in both the United Kingdom and the United States requires deposit-taking banks to adopt forms of “ring-fencing,” restricting risky activities. See Steven L. Schwarcz, Ring-Fencing, 87 SOUTHERN CALIFORNIA LAW REVIEW 69, 78 (2014); also available at http://ssrn.com/abstract=2228742. In the United Kingdom, ring-fencing for banks was first proposed by the 2011 Vickers Report. Id. at 78–79. In the United States, ring-fencing is enshrined in the Volcker Rule. Id. at 80–81.

16 The Dodd-Frank Act sharply limits the power of the Federal Reserve to make emergency loans to individual or insolvent financial firms. That categorical limitation appears somewhat excessive, if not dangerous; a lender of last resort can be an important safeguard if it acts judiciously.
17 See, e.g., Marius A. Boewe et al., The European Central Debt Crisis – Paving the Way Towards Financial Stability, J. BANKR. L. 2012.01-5 (observing that “the European Central Bank (‘ECB’) started to purchase sovereign debt [from European banks] and continued to accept sovereign debt as collateral without haircuts”).
Liquidity can also be used to stabilize systemically important financial markets.\textsuperscript{18}

For example, in response to the post-Lehman collapse of the commercial paper market, the U.S. Federal Reserve created the Commercial Paper Funding Facility (‘‘CPFF’’) to act as a temporary lender of last resort for that market, with the goal of addressing ‘‘temporary liquidity distortions’’ by purchasing commercial paper from highly rated issuers that could not otherwise sell their paper.\textsuperscript{19} The CPFF apparently helped to stabilize the commercial paper market.\textsuperscript{20}

Regulators should consider institutionalizing liquidity to stabilize systemically important financial markets. To mitigate moral hazard, at least part of the source of liquidity could be privatized.\textsuperscript{21} Flexible pricing approaches used in structured financing transactions could also be adapted to calculate the purchase price of market securities at levels that stabilize markets without fostering moral hazard.\textsuperscript{22} This type of targeted approach to

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\textsuperscript{18}I first proposed this in Systemic Risk, 97 GEORGETOWN LAW JOURNAL 193, 225-30 (2008); also available at http://ssrn.com/abstract_id=1008326.
\textsuperscript{19}See Tobias Adrian, Karin Kimbrough, & Dina Marchioni, The Federal Reserve’s Commercial Paper Funding Facility, FED. RESERVE BANK OF N.Y. STAFF REPORT NO. 423 (April 1, 2010).
\textsuperscript{20}Id. at 11 (concluding that ‘‘[t]he CPFF indeed had a stabilizing effect on the commercial paper market’’).
\textsuperscript{22}Id. at 833. For example, assume that the intrinsic value—effectively the present value of the expected value of the underlying cash flows—of a type of mortgage-backed security is estimated to be in the range of 80 cents on the dollar. If, due to panic, the market price of those securities had fallen significantly below that number, say, to 20 cents on the dollar, a liquidity provider could purchase these securities at, say, 60 cents
\end{flushleft}
use liquidity to stabilize panicked financial markets is fundamentally different from quantitative easing ("QE"), which refers to a central bank purchasing government (and sometimes other) securities as a form of monetary policy, in order to hold down interest rates.\textsuperscript{23}

B. Credit Sources Should be Diversified

Diversifying sources of credit availability might increase financial stability. My analysis below assumes that each diversified credit source is robust and that it does not create an incentive-distorting liquidity glut\textsuperscript{24} or inappropriately weaken central bank control over monetary policy.

Consider, for example, the European Commission’s proposed Capital Markets Union ("CMU"), which has the goal of reforming the European financial system to help build an integrated European capital market by


2019.\textsuperscript{25} Such a capital market is expected to increase business financing and, more relevant to my talk today, to diversify it beyond bank lending\textsuperscript{26} — which currently represents around 80% of European corporate debt financing.\textsuperscript{27}

The CMU focuses on securitization (in Europe spelled securitisation) as one of the central sources of diversified credit. In a typical securitization transaction, a sponsor will either originate a pool of loans or other rights to payment, or purchase those types of financial assets from other originators (such as mortgage lenders), and sell them for cash to a special purpose entity (“SPE”). To raise the cash, the SPE issues securities to investors, repayable from the periodic financial asset payments. Securitization thus enables lenders to multiply their available funding by selling existing loans for cash, which can be used to make new loans. Otherwise lenders would have to carry the loans on their books and recoup the principal over many years.\textsuperscript{28}

Used legitimately, securitization became “one of the dominant means of capital formation” in the United States and abroad.\textsuperscript{29} In 2007, for

\textsuperscript{27} Kira Brecht, \textit{How U.S. and EU Capital Markets are Different} (Oct. 29, 2015), available at \url{http://openmarkets.cmegroup.com/10431/how-u-s-and-eu-capital-markets-are-different}.
\textsuperscript{28} See generally Steven L. Schwarcz, \textit{What is Securitization? And for What Purpose?}, 85 \textit{Southern California Law Review} 1283, 1295-98 (2012); also available at \url{http://ssrn.com/abstract=1996670}.
example, the volume of European securitization approximated €595 billion. During that period, the volume of securitization in the United States approximated $11.2 trillion.

The levels of securitization dropped precipitously, however, with recognition that its abuses contributed to the financial crisis. By 2015, for example, the volume of European securitization was only €214 billion and the volume of U.S. securitization was relatively lower, only $1.9 trillion. Securitization’s abuses centered around the highly leveraged securities, already mentioned, which were extremely sensitive to cash-flow variations and overly dependent on collateral-value assumptions.

The revival of securitization—and thus the CMU’s goal to further facilitate securitization as a source of capital market financing—will depend on preventing future such abuses. To accomplish that, the European Commission is proposing a framework for what it calls simple, transparent,
and standardised (“STS”) securitization, which is designed to increase reliability and investor confidence.35

C. System-Wide Flaws Should be Identified and Corrected

Regulators should try to identify and correct system-wide flaws in making credit available. Consider the following potential flaws.

1. **Overreliance on Credit Ratings.** A credit rating is a formal assessment of a borrower’s ability to pay its debts, expressed by private for-profit companies—known as “rating agencies”—through an ordinal ranking system.36 In general, the higher the rating, the more likely the borrower is to pay its liabilities.37 Because of their simplicity and public availability, credit ratings can perform a public good, helping to close the information gap between borrowers and lenders.38 Further, credit ratings also serve a de facto “certification” function by allowing investors to compare the creditworthiness of debt securities with different risk characteristics.39


36 PRAGYAN DEB, MARK MANNING, GARETH MURPHY, ADRIAN PENALVER & ARON TOTH, BANK OF ENG., WHITHER THE CREDIT RATINGS INDUSTRY? 4 (2011), http://www.bankofengland.co.uk/financialstability/Documents/fpc/fspapers/fs_paper09.pdf. For example, Moody’s represents the most creditworthy instruments as Aaa, the next most creditworthy as Aa, then to A, then to Baa, and so on. *Ratings Definitions*, MOODY’S, https://www.moodys.com/Pages/amr002002.aspx.


39 Id. at 5–6.
Investors both in the United States and abroad came to rely on credit ratings as simple tools to assist in making investment decisions. \(^{40}\) Because of their widespread use, \(^{41}\) however, many investors overrelied on credit ratings. Prior to the financial crisis, for example, investors often relied exclusively on credit ratings without performing independent credit examinations. \(^{42}\) Such exclusive reliance reflected a faith “in the accuracy of credit ratings [that] was reinforced by their long record of reliability for assessing the creditworthiness of borrowers under relatively simple debt instruments, such as corporate bonds and basic securitization instruments.” \(^{43}\)

This faith remained steadfast even as credit ratings were applied to much more complex, highly leveraged, and novel instruments, such as ABS CDO securities, \(^{44}\) without historical performance data. \(^{45}\) But the faith was badly shaken when “the rating methodologies utilized for . . . [those] securities produced inaccurate ratings.” \(^{46}\) The resulting loss of investor confidence caused a collapse of the market for virtually all debt securities, and a corresponding collapse of credit. \(^{47}\)

This overreliance on credit ratings even when extrapolated far beyond their normal use, and the resulting collapse of credit caused by the loss of

\(^{41}\) \textit{See id.}
\(^{43}\) \textit{Id.}
\(^{44}\) \textit{See supra} note 6 and accompanying text (defining these securities).
\(^{45}\) Schwarcz & Chang, \textit{supra} note 42, at 773–75.
\(^{46}\) \textit{Id.} at 777.
\(^{47}\) \textit{See supra} notes 7-9 and accompanying text.
faith in ratings even when normally applied, illustrates a system-wide flaw in making credit available. How can regulators try to correct this flaw?

One approach might be to require “periodic self-awareness and reporting” from the financial community of the limitations of credit ratings and their potential for failure. This requirement would be especially valuable when extrapolating existing ratings methodologies to novel financial products.

Another approach might be simply to try to demystify credit ratings, reducing the blind faith that can cause overreliance. The Dodd-Frank Act implicitly attempts to do that by requiring the U.S. Securities and Exchange Commission to adopt new rules requiring disclosure of rating methodologies, thereby increasing the transparency of the rating process. This enables investors themselves to better understand the limitations, as well as benefits, of credit ratings.

48 Schwarcz & Chang, supra note 42, at 783. A similar requirement was passed as part of the Basel III capital adequacy guidelines, whereby banks are required “to engage in periodic financial ‘stress’ scenarios, in order to motivate them to consider the possibility of, and to better prepare for, future periods when previously adequate liquidity and capital resources might prove inadequate.” Id. at 782–83. Further, the Dodd-Frank Act “requires banks and other systemically important financial institutions to plan for the possibility of their liquidation.” Id. at 783.

49 Id.


51 See Gregory A. Fernicola & Joshua B. Goldstein, Credit Rating Agencies, SKADDEN, at 1–2, https://www.skadden.com/newsletters/FSR_Credit_Rating_Agencies.pdf (“To increase transparency in the ratings process, rating agencies will be required to use a standardized form to publicly disclose their rating methodology, a description of issuer data considered in the rating process and any additional information that the SEC may require.”).
2. *Marking-to-Market in Crisis Conditions.* Marking-to-market is widely considered to protect against declines in market value. In turbulent or panicked markets, however, it can reduce credit availability and exacerbate the panic.

In its simplest form, marking-to-market refers to the common regulatory requirement that a securities account be adjusted in response to a change in the market value of the securities. An investor, for example, may buy securities on credit from a securities broker-dealer, securing the purchase price by pledging the securities as collateral. To guard against the price of the securities falling to the point where their value as collateral is insufficient to repay the purchase price, the broker-dealer requires the investor to maintain a minimum collateral value. If the market value of the securities falls below this minimum, the broker-dealer will issue a “margin call” requiring the investor to deposit additional collateral, usually in the form of money or additional securities, to satisfy this minimum. Failure to do so triggers a default, enabling the broker-dealer to foreclose on the collateral.

Requiring investors to “mark to market” in this fashion is generally believed to reduce risk. Nonetheless, it can cause “perverse effects on

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52 This discussion of marking-to-market is based on Steven L. Schwarcz, *Regulating Complexity in Financial Markets*, 87 WASHINGTON UNIVERSITY LAW REVIEW 211, 232-33 (2009); also available at http://ssrn.com/abstract id=1240863.
53 *Id. See also* Zvi Bodie, Alex Kane & Alan J. Marcus, *Investments* 71–72 (8th ed. 2008).
systemic stability” during times of market volatility, when forcing sales of assets to meet margin calls can depress asset prices, requiring more forced sales (which, in turn, will depress asset prices even more), causing a downward spiral.\textsuperscript{55} The existence of leverage makes this spiral more likely and amplifies it if it occurs.\textsuperscript{56} At least some portion of the financial crisis appears to have resulted from this downward spiral.\textsuperscript{57}

Marking-to-market’s inadvertent undermining of financial stability is due in part to nonlinear feedback effects and tight coupling.\textsuperscript{58} Nonlinearity results when “interactions among components of a system are not directly proportional.”\textsuperscript{59} Similarly, a “tightly coupled system is one that is highly interdependent, so that a disturbance to one part of the system can spread almost instantaneously to other parts of the system.”\textsuperscript{60} In a downward

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\textsuperscript{55} Rodrigo Cifuentes, Gianluigi Ferrucci & Hyun Song Shin, \textit{Liquidity Risk and Contagion} 2 (Bank of Eng. Working Paper No. 264, 2005), available at http://www.bankofengland.co.uk/publications/workingpapers/wp264.pdf); see also Clifford De Souza & Mikhail Smirnov, \textit{Dynamic Leverage: A Contingent Claims Approach to Leverage for Capital Conservation}, JOURNAL OF PORTFOLIO MANAGEMENT, Fall 2004, at 25, 28 (arguing that, in a bad market, short-term pressure to sell assets to raise cash for margin calls can lead to further mark-to-market losses for remaining assets, which triggers a whole new wave of selling, the process repeating itself until markets improve or the firm is wiped out; and referring to this process as a “Critical Liquidation Cycle”).

\textsuperscript{56} De Souza & Smirnov, \textit{supra} note 55, at 26–27.

\textsuperscript{57} See \textit{supra} note 9 and accompanying text. See also Rachel Evans, \textit{Banks Tell of Downward Spiral}, 27 INTERNATIONAL FINANCIAL LAW REVIEW 16 (June 2008).

\textsuperscript{58} \textit{Regulating Complexity in Financial Markets}, \textit{supra} note 52, at 232–33.


\textsuperscript{60} Iman Anabtawi & Steven L. Schwarcz, \textit{Regulating Ex Post: How Law Can Address the Inevitability of Financial Failure}, 92 TEXAS LAW REVIEW 75, 94 (2013).
spiring asset market, then, the very fact of forced sale of marked-to-market assets causes the market value of those assets to fall even further, in turn requiring more marking-to-market.\textsuperscript{61} This can create the type of “anomaly, seen during the [financial] crisis, of securities bearing market values substantially below their intrinsic values.”\textsuperscript{62}

Regulators could reduce marking-to-market’s flaws by addressing the nonlinear feedback effects and tight coupling that cause them. To reduce nonlinear feedback, for example, regulators could “allow firms to substitute other measures of investor comfort for marking-to-market”\textsuperscript{63} when marking-to-market “might distort value, such as when it would require a securities account—especially an account whose securities have long-term maturities—to be adjusted in response to short-term pricing fluctuations.”\textsuperscript{64} One such measure of investor comfort might be a firm’s “full disclosure of its underlying asset portfolio.”\textsuperscript{65} And to reduce marking-to-market’s tight coupling, regulators could use liquidity to stabilize systemically important financial markets impacted by a downward spiraling asset market.\textsuperscript{66} Such

\textsuperscript{61} Cf. Richard Bookstaber, A Demon of Our Own Design: Markets, Hedge Funds, and the Perils of Financial Innovation 146 (2007) (observing that “the natural reaction to [financial] market breakdown is to add layers of protection and regulation. But trying to regulate a market entangled by complexity can lead to unintended consequences, compounding crises rather than extinguishing them because the safeguards add even more complexity, which in turn feeds more failure.”).

\textsuperscript{62} Regulating Complexity in Financial Markets, supra note 52, at 247.

\textsuperscript{63} Id. at 246.

\textsuperscript{64} Anabtawi & Schwarcz, supra note 60, at 119.

\textsuperscript{65} Regulating Complexity in Financial Markets, supra note 52, at 246–47.

\textsuperscript{66} See supra note 18 and accompanying text.
liquidity might be provided by the type of market lender of last resort previously discussed.  

3. **Inherent Human Limitations.** I have so far discussed system-wide flaws in making credit available that are part of the design of the financial system. In theory at least, the system can be redesigned to correct them. Another type of system-wide flaw is much more intractable: our inherent human limitations.

For example, we often implicitly simplify our perception of reality as a psychological coping mechanism, including a tendency to define future events by the recent past. This flaw has particular application to credit availability. In this context, consider certain parallels between the Great Depression and the financial crisis, which illustrate how the flaw might temporarily increase but ultimately destroy credit availability.

In the years preceding the Great Depression, banks lending “on margin”—a practice in which borrowers use proceeds of a loan to purchase shares of stock and then pledge that stock as collateral to the banks—assumed they were adequately protected, even for margin loans made to

67 See supra notes 19-20 and accompanying text. Cf. *Regulating Complexity in Financial Markets,* supra note 52, at 246–47 (discussing using such a market liquidity provider to “more loosely couple the feedback effects”) & at 247–56 (generally discussing providing liquidity to systemically important financial markets).

68 For a more comprehensive discussion of how human limitations can impair financial regulation, see Steven L. Schwarcz, “Regulating Complacency: Human Limitations on Legal Efficacy” (draft on file with author).
risky borrowers. Although these loans were not initially overcollateralized—because the value of the pledged stock initially equaled, but did not exceed, the amount of the loan—banks expected the stock market to continue rising, as it had for decades. That expectation reflects the tendency to define future events by the recent past. An increase in stock prices, and thus a consequent increase in the value of the collateral, would then cause the loans to become overcollateralized. Beginning in October 1929, however, the decline in stock prices caused many of those risky borrowers to default on their now-undercollateralized margin loans. That, in turn, caused margin-lending banks to begin defaulting, triggering a banking collapse that ultimately wiped out credit.

Similarly, prior to the financial crisis, institutions that made mortgage loans to subprime borrowers assumed, as mentioned, that they were adequately protected. They expected housing prices to continue rising, as had been the case for decades. That expectation again reflects the tendency to define future events by the recent past. An increase in housing prices, and thus a consequent increase in the value of the collateral, would then cause the loans to become overcollateralized. In the fall of 2007, however, the decline in housing prices caused many subprime borrowers to begin

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70 Id.
71 Id. at 1357.
72 Id. at 1359–60.
73 Id.
defaulting on their now-undercollateralized mortgage loans. As discussed, that started the timeline of events that caused the shutdown of debt markets and the resulting financial crisis.

We do not yet, and may never, understand our human limitations well enough to correct them. If we cannot correct these limitations, they will continue to threaten credit unavailability and resulting financial crises.

III. CONCLUSION

Although the standard story is that the financial crisis resulted in the loss of credit availability, I have argued that a loss of credit availability appears to have caused the financial crisis more than the reverse. If that argument is correct, what lessons can it teach us?

There are at least three. First, in our market-intermediated financial system, credit availability is dependent on financial markets as well as banks. Therefore financial regulation should be designed to protect the viability of markets as well as banks. Second, diversifying credit sources might increase financial stability. Third, we should try to identify and correct system-wide flaws that can undermine credit availability.

75 Anabtawi & Schwarcz, supra note 69, at 1360 (“When home prices began falling, some of these asset-backed securities began defaulting, requiring financial institutions heavily invested in these securities to write down their value, causing these institutions to appear, if not be, financially risky.” (citation omitted)).  
76 See supra notes 5-12 and accompanying text.
One of the most intractable of these flaws is our own inherent human limitations, which we can do little to correct. That suggests an ongoing risk for credit availability, and thus an ongoing potential for new financial crises to arise. Although addressing that risk and crisis-potential is a story for another day, Professor Iman Anabtawi and I begin to address it in a separate article. Because financial failure is inevitable, we argue that financial regulation should be designed not only to prevent failures but also to work ex post—after a systemic shock has been triggered and is being transmitted—to try to stabilize the afflicted financial system. Our approach takes inspiration from chaos theory, insofar as that theory holds that remedies should also focus on limiting the consequences of failures.