Tossing Out the Rules

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Thank you for having me and it's a pleasure to be on campus and to have a chance to talk to you. I am the economics correspondent for the *New York Times* in the Washington Bureau. I have been doing that particular job for about six years now, and before that I was the European economics correspondent for six years in Germany, and a business reporter since the mid-1980s. It's been my fortune to cover this particular crisis, which is by far the most historic story that I've ever covered, and to have watched it through the build-up phase and now through the recovery. If you're in college right now, you should in many ways be thankful that you are living in exactly these times because this is a moment in history that you don't see very often. I've been a journalist for more than twenty-five years, and I never covered anything remotely like this, never lived through anything like this, and if you talk to policymakers at the Federal Reserve— Alan Greenspan, veterans of economic policy going back a lot further than I do—they will tell you the same thing: they've never seen anything like this. This is really an earthquake. It's transformative, it's telling us things we never really understood about our system or ourselves, and we have yet to really understand entirely what happened. And we now have a long process in front of us of figuring out what the real lessons are, and how to prevent this kind of thing from happening again, if indeed that's possible. So just be alert: this is really an extraordinary moment in history, and nobody has the full story yet. We will be digging out the truth for years and years to come.

Let me start by recalling a conversation I had about a year ago with a senior official in the Federal Reserve. I was asking him how it was possible for him and his colleagues to be embracing decisions that went so much against the very DNA of what any mainstream economist and Fed official has been trained for decades to believe in: having the government print vast amounts of money—billions and hundreds of billions and even trillions of dollars—and having the government interfere in the economy in ways that seemed sacrilegious just a few years earlier. And spending: having the government engage in a massive program of deficit spending to head off a crisis. He responded, "You know, economists have a phrase that's applicable here, which is 'regime change.'" I only knew that phrase from the context of the war against Iraq and throwing out Saddam Hussein, but he meant this was a moment in history. A moment when the economy has reached such economic conditions, such an extreme state of crisis that you really had to throw out your entire rulebook because not only do you need to take extraordinary measures, but if you follow the time-tested seemingly-ironclad rules of economic policy in a situation like that, you will cause more harm than good and make the situation worse. That was his basic rationale for being able to justify gigantic bailouts, which are just completely anathema to anybody who believes in the efficiency of free markets and the merits of limited government intrusion.

Regime change. That's what we had, and that's how dire the situation was. It's become a cliché but it really is true that in September of 2008, which is essentially one year after the crisis had actually begun, we suddenly got hit with a huge new wave of stress and difficulty that was close to bringing down the entire financial system. I was in a meeting with the Fed chairman Ben Bernanke in mid-October last year and it was scaring the daylights out of me. He was trying to give me a sense of how paralyzed the credit markets were, and he described how the federal funds rates—the basic target that the Fed has for overnight interest rates—had been spiking up enormously every single morning. Each morning overseas nobody could get their hands on dollars, and there was this tremendous craving for dollars in all the overseas markets because nobody was willing to lend to anybody else; so, the Fed was having a huge demand on its open market operations. He went on to say, "Right now, nobody can borrow money for more than 24 hours at a time."

That is a staggering thought. If you're General Electric or AT&T—a strong blue chip corporation—and you're unable to borrow money for more than a twentyfour-hour period, you cannot function in such an economy. I remember asking him, "Could we just back up a minute and can you please explain to me in terms that our readers could understand, what would be so bad about letting American International Group (AIG) fail because of the reckless decisions it had made, rather than bail it out with eighty-some billion dollars. What would be so devastating about that happening?" He looked at me and said, "If we let AIG fail, as much as I hate to bail it out, the depression will last another ten years." A senior staffer nearby piped up, "Don't you mean the 'recession' will last another ten years?" And Bernanke goes, "No, I mean the *depression* will last another ten years."

He may have been exaggerating, but we now know that the financial system was crumbling, and although out on Main Street there was tremendous hostility to the idea of setting up a $700 billion bailout fund and embarking on another big stimulus program, the state of the financial system was already beginning to cripple the economy. And indeed, that very month, the number of jobs lost soared from about 100-200,000 to 600-700,000 jobs lost per month. We didn't know the job numbers in September of 2008 for that month, but we would find out. If you looked back a couple of months later you could see that, indeed, all kinds of basic economic indicators just fell off the cliff: consumer spending, the housing market, business investment, and GDP growth. We had gone from a recession to a really steep recession, and things were falling apart fast.

How did we get ourselves into this mess? To back up again, in addition to my role as the economics correspondent for the *Times*, I am also the author of the book *Busted: Life Inside the Mortgage Meltdown*. This is where it gets really embarrassing, because even though I am an economics correspondent, and even though I had written some articles warning about exotic mortgages in early 2004, I plunged into them myself. I was part of the madness. I was divorced at the time, making huge child support and alimony payments (I had less than half of my disposable income actually coming to me each month), but I was in love and wanted to get married. We both have kids and so we wanted to have a house. Enflamed with the euphoria of love and the excitement of starting a new chapter of my life, and against all of my better judgment, I decided to take the plunge and get a mortgage. It was unbelievable. My mortgage broker was a guy named Bob Andrews—no relation—and he made it the easiest thing in the world for a guy like me to borrow almost a half a million dollars.

Later I asked Bob, "So, what do you think about your own role in all of this?" And he said, "Well, I'll tell you, Ed. My job is to sell money. My job is to be an enabler of the American dream. And so if you come to me and you say, 'Bob, I've been unemployed for seven years, I don't have a pot to piss in'"—that's exactly what he said—"but you want to buy a house, then I will see what I can do to get you a house. I'll do anything I can within the rules. And if there's a way to do it within the rules, I'll get you a mortgage. It's your job to figure out whether you can afford it. That's not my problem." You've heard about "no doc" loans, or stated-income loans, where you don't have to document how much you say you earn. What people were doing, of course, was exaggerating how much they earned so that they qualified for a mortgage. My situation, for intricate reasons, actually didn't allow for that, so we took it down a step: we did what was called a no-ratio loan in which I didn't even tell them what my income was. That part of my loan application was literally left blank. And they approved it. They approved it! Amazing! Later, when I looked at the mortgage documents more closely, I realized the space was absolutely left blank. And Bob said, "Yeah, well, we just had to do it that way, pay an extra quarter point, and they're going to make their decision based on the fact that you have a good credit score and you have a job, and we're not going to ask anymore questions after that." That's how it went.

So that was my introduction to the insanity of the mortgage market. I was saying to myself, "This is the craziest thing I've ever seen; I just hope I don't get burned by it," which, of course, I did. By the time I got to writing the book, I was way, way behind on the mortgage. I still am, and I am in negotiations with the bank, now JP Morgan-Chase, my third lender, and we'll see how that goes. I would dearly love to get out of the house and go to a two-bedroom apartment and start life over. I recommend that to anybody in this room: don't bite off more than you can chew. The temporary pleasure that comes from having the house of your dreams doesn't compare to the agony of not knowing how to pay your bills month in and month out.

What I wanted to do in writing the book, *Busted*, was not only to tell this silly story of my own experience, but to make my whole story a case study in order to shed some light more broadly on how this mortgage meltdown came about. A lot of things obviously were going wrong in this country in order to lead up to this, but it is still a mystery why fifteen to eighteen million people basically started heading off of a cliff at the same time. It will always be the case that some people will be imprudent, and that some people will have their houses foreclosed on. But it's never been the case that millions and millions of people did it in the same year. I of course was swept up in it, but it wasn't just me: it was also my lenders and the Wall Street guys behind them. So what *Busted* is basically about is not only the arc of our own story, but also the stories of the people who loaned me the money, and the Wall Street guys who financed them, and then my friends in Washington, Alan Greenspan and that crowd, who were ultimately the enablers for the whole process.

I am proud to say that I outlasted two of my three mortgage lenders. The first, American Home Mortgage, whom Bob worked for, went bankrupt before I had missed my first payment. Their story is, I think, very illustrative. It took me a long time and quite a lot of reporting to really understand what happened with this company. American Home Mortgage started in 1988 out of a guy's bedroom, and by the time that I came along, it was doing about forty billion dollars a year in mortgages. It was a nationwide mortgage lender, not a bank, and at its peak in 2007 it was approaching sixty billion dollars a year in mortgage loans. What happened? American Home Mortgage went bankrupt almost overnight in August of 2007, right when the first wave of the financial crisis really began to hit. That crisis was precipitated by Moody's and Standard and Poor's, two big credit-rating agencies, simultaneously downgrading a bunch of mortgage-backed securities. They essentially confessed for the first time that they had been completely wrong on evaluating mortgage-backed securities backed by subprime mortgages, that they had completely understated the risks. When they did that, the entire investment world knew that the jig was up, and that that first wave of hundreds of securities was going to be followed by all of the rest of it. They had downgraded just a tiny fraction of the total volume of securities backed by subprime mortgages, so everybody knew that the remaining ninety-plus percent was going to get downgraded too. The markets began to freeze up and so American Home Mortgage, which owed a lot of money, suddenly had its credit lines cut off, its source of oxygen cut off, and it went bankrupt overnight.

What's really interesting about this story, though, gets to the mystery and the human element of this whole crisis. This company had been doing so well selling exotic mortgages—not really subprime mortgages, just no doc loans to people like me—and were getting more and more aggressive about it. The company decided that it wasn't good enough just to make these exotic mortgages and then resell them to Wall Street, which would then package them and turn them into securities and sell them off to investors with triple-A ratings. American Home Mortgage decided that it wanted to hold a lot of these mortgages, and since it didn't have the capital to back that up, it borrowed the money to essentially buy its own mortgages and hold them. The company had a leveraged portfolio of fifteen to eighteen billion dollars worth of its own riskiest mortgages. These were basically what were known as option-arm mortgages, which were the vilest of all of the exotic mortgages invented throughout this period—worse by far in their structure than even the nastiest of the subprime loans. So when suddenly the faith in the value of these kinds of mortgages collapsed and markets seized up in August of 2007, the company had its credit lines pulled and it went down overnight. It didn't even register a losing quarter. It just went bankrupt overnight and seven thousand people were out of work.

So you have a situation where it's not just super-cynical Wall Street people and lenders deceiving borrowers like me. You have the so-called smart money deceiving itself, drinking the Kool-Aid and thinking that this really is, maybe, a good profit-making opportunity. And indeed, that's not unique. If you look at the big disaster bailouts that we've had, Citigroup and Merrill-Lynch, these companies essentially were caught holding billions and billions of dollars of toxic assets they knew were bad, but got stuck with. Some of them were playing a game of musical chairs and they didn't grab the chairs fast enough, they didn't unload their securities fast enough. But some of them basically thought that this was the way to make money. Merrill-Lynch was buying subprime mortgage lenders at top-dollar as late as January 1, 2007. This is just mind-boggling. So you have this smart money drinking their own Kool-Aid in case after case.

What else did I learn through this process? Well, a lot of people blame the credit-rating agencies for having enabled this horrible process of taking toxic subprime loans (which had very poor chances of being repaid), bundling them into securities, and getting those securities triple-A ratings. The credit-rating agencies became corrupted, having signed triple-A ratings to well over a trillion dollars' worth of mortgage-backed securities that were really not worth anything close to their face-value. When I looked at the rationale for how the credit-rating agencies reached those decisions, I became convinced that you can't just ascribe this to people getting their mathematical models wrong, or to bad calculations, or to just bad judgment. The flaws in their thinking were so basic that you really have to write it down to something analogous to criminal negligence. To give you just a very simple example: the credit-rating agencies were taking in and evaluating hundreds of billions of dollars worth of securities that were backed by the worst mortgages in the world. We're talking about pools of mortgages where the prospectus said, very clearly, the average credit score was below 600, which is to say, really bad. More than half of the loans were no doc loans. Of those, almost all were no-money-down loans. There was no equity in the houses of the borrowers who were getting the loans. So you had bad credit ratings, no money down, and undocumented incomes and financial conditions, and then people were being stretched with these subprime loans, where they began with teaser rates and then later got hikes in their monthly payments. Impossible situations, right? Triple-A ratings, right there in black and white. But what the rating agencies concluded was that until as late as 2006, even in the worst case scenarios, if you had a recession and things went bad, maybe you'd lose about 4% of that pool to loan defaults at the end of every day. Their basis for saying that was, "Well, we're looking here at the repayment rates and the foreclosure rates on subprime loans, and they've been really good, they've been lots lower than 4%, and even in the 2001-2002 downturn they didn't get any higher than 4%, so that sounds pretty reasonable." Pretty reasonable except for two things: first, the subprime loans in 2005 were far riskier, a whole different breed than anything that had existed in 2001; and second, in 2001 you had an almost-unique recession where housing prices continued to rise rapidly because the Fed was underwriting the housing market with very low interest rates. And still, the rating agencies seemed to be completely confident that they had this all figured out, but they didn't. I don't believe you can attribute that kind of flawed thinking just to analytical muddiness. Those are flaws that are just too basic to ascribe to anything less than willful negligence.

This brings us to the situation we're in today. The economy has been through a terrible crisis, a mortgage meltdown that turned out to be much more interconnected with the rest of the world than anybody had imagined, and it seems we are now coming out of the worst recession in at least the post-war period. Some people would argue that this recession is worse even than that of the Great Depression in terms of the number of financial institutions that have been toppled. But in any case, we're coming out of it—slowly, painfully—and we're asking ourselves what the lessons are. I don't have any quick answers to that, but obviously we're in the middle of a huge debate about the role of government regulation. Everybody now says we need more regulation. Even people from the banking industry will tell you that, and they will also say that we need reform. But the question will be what kind of reform, how much regulation, and, when push comes to shove, how much will the big Wall Street firms and banks resist it? I can guarantee you they're going to resist regulation as much as they can; even in their weakened situation, they've actually already been pretty successful already at resisting regulation.

But as we go forward, I certainly take out of this a couple of basic lessons. One is that protecting consumers, it turns out, is not just a matter of keeping innocent people from being victimized by bad business practices. It's also important for systemic reasons. If the Federal Reserve had used its authority to rein in and prohibit a lot of the worst mortgage practices that existed at the height of the housing bubble, at least some of this crisis would have been avoided. It had the power, but it didn't really want to get into the business of second-guessing the choices that borrowers and lenders were making.

That leads to the second lesson, or question: If you're going to have the Federal Reserve or some other government agency impose more regulation both on business practices and on what consumers can do, what's your basis for doing that? Here I would recommend a book by George Akerlof and Robert Shiller called *Animal Spirits: How Human Psychology Drives the Economy, and Why It Matters for*

Global Capitalism. The authors look at the behavioral aspects of economics, a subject that has been mostly avoided by economists for generations. They argue that there's a lot of irrational behavior that goes on in the world and somehow we need to take account of it. When it comes to regulation, Akerlof and Shiller come up with the basic analogy of parental supervision: a good parent is one who wants to encourage his or her child to grow and to flourish and to try new things, but at the same time reins the child in from being self-destructive. And what we we've discovered over the last couple of years is that contrary to the dogma of pure free market champions and to the conventional wisdom, free and efficient markets do not always self-correct. In some cases—and this is one of them—they self-destruct. I don't buy for a minute the argument that this crisis was the result of too much government intervention. Government policy definitely played a role, but I can say that what we had here was the complete absence of supervision and thus a competitive frenzy that ultimately led to very self-destructive behavior.

As I have watched some of this process in Washington, and as people have tried to get through the crisis and figure out how to prevent the next one, it's astonishing to see how shameless the financial industry can be. They're quick to talk about the obvious need for reform, but when the rubber meets the road and it gets down to something that they don't like, they will push back, and it's astonishing how much they've been able to stop already. So this is going to be a fight. I can imagine a situation—one we need to guard against—where political leaders overreact with too much regulation and rigidity in some areas, and at the same time cut too many deals for the banks. In other words, we could be subsidizing them outside the door with guarantees and government loans on the one hand, and then over-regulating them on the other. We could have the worst of all worlds.

It's going to be a very tough thing to get through. We do want dynamism and flexibility in our economy and our financial system. The government is not very good at second-guessing the markets or private individuals in their economic transactions. But clearly the government does have a role, and figuring that out will be hard. Things became so extreme in the last couple of years on the deregulatory front that it seems like you can solve a lot of problems now simply by imposing common-sense regulation, some of which already is being imposed. One example: the Federal Reserve is already mandating that mortgage lenders demonstrate a borrower's realistic ability to repay the mortgage. This is not just about making them document the loan, but not allowing a mortgage lender to qualify a borrower on the basis of a really low teaser rate, knowing that monthly payments will go up dramatically in two or three or five years. That's a really basic, simple concept that isn't too hard to learn and that can be done. But there are many vastly more difficult questions, such as how to regulate things like derivatives, which we're going to battle over in the next year or so. They don't have easy answers, and there are good arguments on a lot of sides. Sometimes the questions will come down to the question of yes, you know this particular kind of financial innovation offers a lot of real benefits in terms of risk management to companies. Is the value of those benefits worth the potential risk that we had build up in the system in the run-up to this crisis? Is the benefit that certain economic actors are getting right now from these securities worth the unknowable, but potentially very significant, danger of risk building up in ways we don’t quite understand?