VOLUME XII, NUMBER 1, WINTER 2011/12

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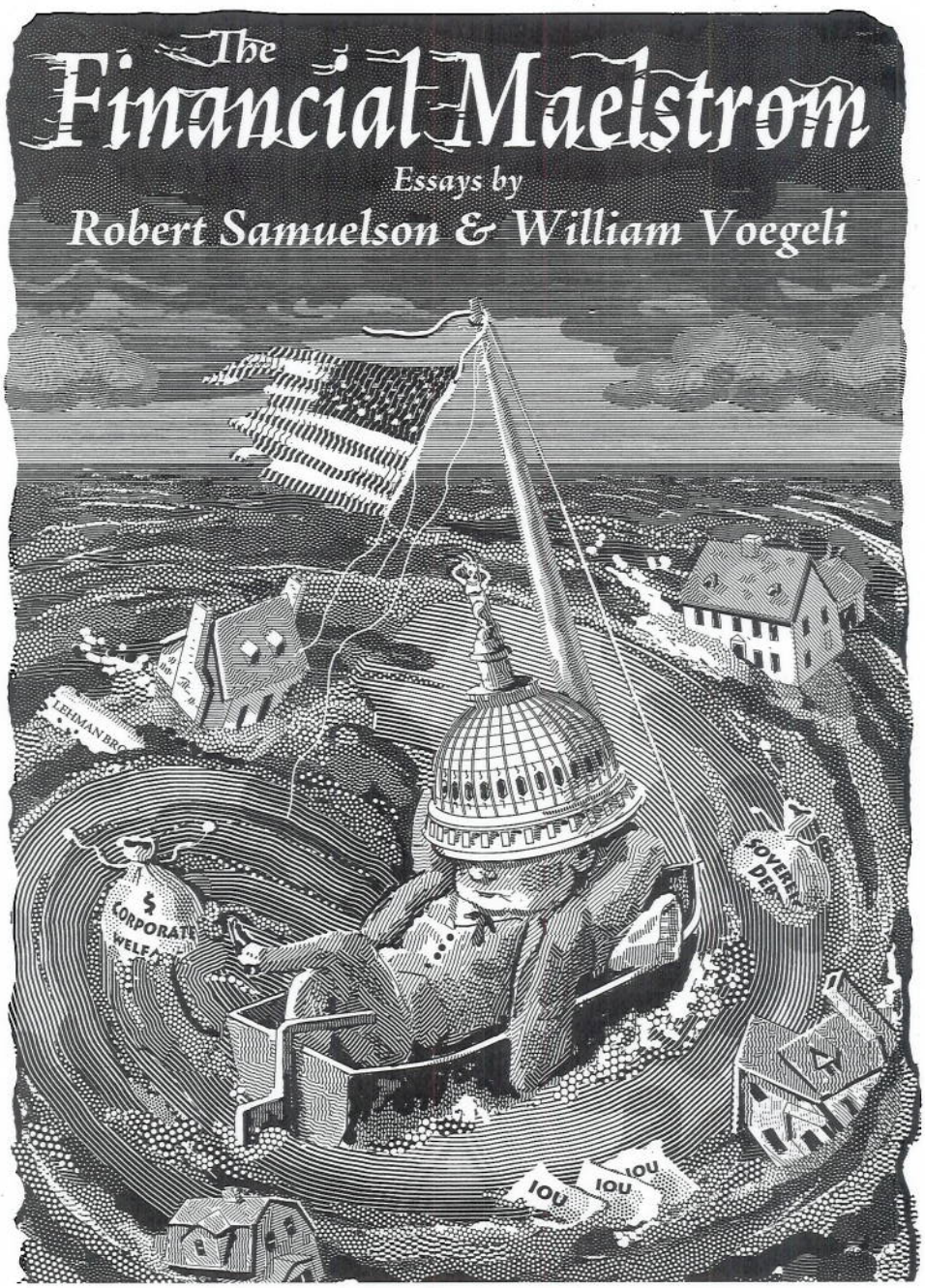

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CLAREMONT REVIEW OF BOOKS
VOLUME XII, NUMBER I, WINTER 2011/12

RECKLESS OPTIMISM

Essay by Robert J. Samuelson

PEOPLE, BUSINESSES, AND GOVERNMENTS borrow for one of two reasons: hopeful optimism or fearful desperation. If it's the first, borrowers see a rosy future. They expect to enjoy the fruits of their loans which, when they come due, will either be repaid or refinanced. Because everyone is upbeat, credit is easy to find and relatively cheap. Desperate borrowers, by contrast, are up against the wall. They urgently need the money, but their repayment prospects are cloudy and, therefore, they struggle to secure credit that, if available, often carries crushingly high rates.

By and large, the borrowing that led to the devastating 2007-09 financial crisis was of the first type. Borrowers and lenders alike shared a sunny outlook. Credit was plentiful, and terms were attractive. The overwhelming majority of borrowers expected to repay, and the overwhelming majority of lenders expected to be repaid. To be sure, some predatory lenders aimed to squeeze their hapless debtors, just as some dishonest borrowers hoped to make a quick buck by taking out a loan, buying a home and either flipping it for a quick profit or, if they couldn't sell, defaulting on the loan. But these abusive practices were a distinct minority.

Against this backdrop, a crucial question emerges: where did the optimism come from? If we can answer that, we can go a long way to understanding how and why the financial crisis developed. It's the pivotal issue.

Debating the Conventional Wisdom

AT FIRST BLUSH, THE ANSWER SEEMS clear. Since the crisis, a standard explanation has gained widespread acceptance. Greed, deregulation, and overconfidence are the culprits. They spawned practices that, though initially rewarding for borrowers and lenders alike, led to calamity. Mortgage brokers relaxed lending standards. Banks and investment banks packaged suspect mortgages in opaque securities that were purchased by all manner of investors. Government regulators, asleep at the switch, blessed these practices by their silence. Everyone's optimism fed everyone else's. It was a toxic brew. Academics, political leaders, and much of the media have embraced this theory. Indeed, it provided the intellectual foundation for the post-crisis Dodd-Frank legislation that overhauled the financial system.

On inspection, however, the conventional wisdom has at least two shortcomings. First, it doesn't really answer the question: *why* was everyone so optimistic? It blandly blames "markets" but doesn't say why everyone became optimistic simultaneously. The second problem is that this mainstream theory could also be wrong. Despite its widespread acceptance, there has always been a competing narrative that blames the boom and bust on mistaken government policies. Presidents and congressional leaders of both parties enthusiastically promoted homeownership—a pillar of the American Dream—and, in so doing, encouraged the lax lending that undermined the financial system.

Not surprisingly, the contending theories reflect politics. While the Left blames "the markets," the Right fingers government and politicians. Who's correct? Could both be right—or wrong?

We now have two new books that favor the alternative thesis: *Reckless Endangerment: How Outsized Ambition, Greed, and Corruption Led to Economic Armageddon* by Gretchen Morgenson, a Pulitzer-prize winning reporter and columnist for the *New York Times*, and Joshua Rosner, a financial consultant; and *Guaranteed to Fail: Fannie Mae, Freddie Mac, and the Debacle of Mortgage Finance* by Viral V. Acharya, Matthew Richardson, Stijn Van Nieuwerburgh and Lawrence J. White, all economists at New York University's Leonard N. Stern School of Business.

As their titles and professional affiliations suggest, these books differ dramatically in tone and approach. The Morgenson-Rosner book is essentially journalistic, telling a story

of shortcomings, excesses, and villains. By contrast, the scholarly NYU tome focuses on policy mistakes and perverse incentives. Still, both books place Fannie Mae and Freddie Mac at the center of the crisis. These massive, congressionally-created mortgage companies (commonly called GSEs for "Government Sponsored Enterprises") stand accused of spawning destructive lending practices in order to placate politicians' obsession with expanding homeownership.

Fannie and Freddie

In 1938 congress created the federal National Mortgage Association (Fannie Mae), a government agency whose mission was to bolster housing construction by buying mortgages insured by the Federal Housing Administration (FHA). In 1968, Congress converted Fannie Mae into a private company at the behest of the Johnson Administration, which—facing budget deficits—wanted Fannie's spending and borrowing off the government's books. In 1970, Congress created the Federal Home Loan Mortgage Corporation ("Freddie Mac"), also off-budget, to buy mortgages from savings and loan associations. In the 1970s and '80s, Congress progressively expanded the GSEs' powers. Fannie Mae, for example, was freed from just buying FHA or Veterans Administration-backed mortgages. Similarly, Freddie Mac was no longer restricted to buying loans from S&Ls.

As private companies, though, Fannie and Freddie were special, imbued by Congress with advantages over competitors. By far the largest was something unstated: the belief—which turned out to be true—that because the government created both Fannie and Freddie, it would ultimately cover their bets if that proved necessary. This implicit but universally believed guarantee enabled the GSEs to borrow at lower interest rates than their major rivals, private banks and mortgage firms. By sharing some of this advantage with borrowers in the form of lower interest rates, Fannie and Freddie could attract a growing share of the nation's mortgage business.

In addition, Congress set extremely low capital requirements, capital being shareholders' money that can absorb losses. On GSE-held mortgages the requirement was only 2.5%—that is, for every $100,000 mortgage they held, Fannie and Freddie needed only $2,500 in capital. In addition to buying individual mortgages, Fannie and Freddie also assembled them into securities, guaranteed those securities, and sold them to investors. The capital requirement on these guarantees was even lower: $450 on a $100,000 mortgage. Fannie and Freddie were not required to submit prospectuses to the Securities and Exchange Commission for approval—something mandatory for any private firm—before selling hundreds of billions of dollars of securities to investors. Finally, Congress exempted the GSEs from paying the state and local taxes that their competitors had to pay.

Books discussed in this essay:

Reckless Endangerment: How Outsized Ambition, Greed, and Corruption Led to Economic Armageddon, by Gretchen Morgenson and Joshua Rosner. Times Books, 352 pages, $30

Guaranteed to Fail: Fannie Mae, Freddie Mac and the Debacle of Mortgage Finance, by Viral V. Acharya, Matthew Richardson, Stijn van Nieuwerburgh, and Lawrence J. White. Princeton University Press, 232 pages, $24.95

Fool's Gold: How the Bold Dream of a Small Tribe at J.P. Morgan Was Corrupted by Wall Street Greed and Unleashed a Catastrophe, by Gillian Tett. Free Press, 294 pages, $26 (cloth), $16 (paper)

The Financial Crisis Inquiry Report. Public Affairs Reports, 547 pages, $14.99

The End of Wall Street, by Roger Lowenstein. The Penguin Press, 384 pages, $27.95 (cloth), $17 (paper)

Blessed with these advantages, Fannie and Freddie's business boomed. The companies became highly profitable and increasingly dominated the home loan market. The figures seem astonishing even now. In 1981, Fannie and Freddie accounted for 7.1% of the residential mortgage market. By 1991, the proportion was 28.4% and by 2002, 44.7%. Shortly before the housing boom crested, in other words, Fannie and Freddie had either issued or guaranteed nearly half of America's mortgages.

Changing the Rules

In theory, this situation could have continued indefinitely. Most home mortgages were relatively safe investments, and Fannie and Freddie's lending standards were conservative. In the main, the GSEs bought and guaranteed loans with sizeable down payments, typically 20%, for borrowers who could be expected, based on their incomes and credit histories, to meet their monthly mortgage payments with little difficulty. By regulation, the GSEs were not allowed to deal in mortgages above a given amount ($417,000 in 2007, before the crisis). Private lenders, therefore, were left with both the larger and the riskier mortgages, all of which were called "non-conforming" loans because they didn't fit the GSEs' criteria. The GSEs seemed to have a lock on the "conforming" market, the bigger, safer part of the mortgage business.

But in 1992 Congress changed the rules of the game. It charged Fannie and Freddie with boosting homeownership among poor and minority families. It did this by adopting a series of complex, overlapping housing "affordability" goals. These came in three varieties: 1) a "low and moderate" income goal, targeting borrowers earning no more than an area's median income; 2) an "underserved area" goal, targeting people in neighborhoods whose residents earned 90-95% of an area's median income; and 3) a "special affordable" goal, focused on people earning no more than 60% of an area's median, or living in exceptionally poor neighborhoods. Congress justified these goals by contending the GSEs should advance policy objectives because the federal government had conferred so many advantages upon them not available to their competitors. The legislation delegated to the Department of Housing and Urban Development the power to increase Fannie and Freddie's affordability goals, which it did. In 1993, the "low and moderate income goal" was 30% of the GSEs mortgages. By 2008, it was 56%. From 1993 to 2008, the "underserved area" goal went from 30% to 39%.

To Morgenson and Rosner, the housing affordability goals led "more than any other single act...to the disastrous home lending practices of the 2000s." To the Stern School economists, the combination of ambitious affordability goals and the GSEs' lax capital requirements transformed Fannie and Freddie collectively into "the largest hedge fund on the

planet." Each backed hundreds of billions of dollars of ever-riskier home loans, which generated high profits in good times but exposed them to enormous losses, should the economy weaken. Losses then might swamp the GSEs' thin capital base.

James Johnson, Fannie Mae's chief executive officer from 1991 to 1998, is Morgenson and Rosner's chief villain. They portray him—a mild-mannered political junkie from Minnesota who managed Walter Mondale's 1984 presidential campaign—as cynically refashioning Fannie Mae into a machine that guaranteed its insiders would do well by trading on its reputation for doing good. Johnson made $100 million at Fannie, Morgenson and Rosner write, though they provide no source. He belonged to Washington's respectable elite, serving as the chairman of the overseeing bodies of both the John F. Kennedy Center for the Performing Arts and the Brookings Institution, the city's best-known think tank.

Something for Nothing

"American government policies that support homeownership are among the most efficient and effective ever devised," Johnson said in a 1998 speech at the National Press Club. That was his mantra: the "public-private partnership" for housing was a huge success and Fannie Mae was "at the heart" of this pragmatic alliance. To publicize his views further, Johnson published a book, *Showing America A New Way Home: Expanding Opportunities for Home Ownership* (1996). But Johnson's behind-the-scenes tactics were less cerebral and more cold-blooded, Morgenson and Rosner show. From 1989 to 2009, Fannie Mae spent roughly $100 million on campaign contributions and lobbying, according to the Center for Responsive Politics. "The old political reality was that we always won, we took no prisoners, and we faced little organized political opposition," Daniel Mudd, one of Johnson's successors, later wrote.

Always, the lobbying aimed to preserve GSE privileges that were crucial to profits. When the Treasury Department was preparing a report in the mid-1990s that suggested genuinely privatizing the GSEs—explicitly ending any government guarantee—Fannie lobbied hard against it. The report was watered down. When a Congressional Budget Office (CBO) study estimated the government guarantee in 1995 was worth $7 billion, one third of which went to shareholders (in higher profits) and executives (in higher compensation), Fannie unsuccessfully lobbied to have the report suppressed. June O'Neill, then the CBO's head, recalled meeting the Fannie executives: "All of us had the same feeling—that we were being visited by the mafia."

The lobbying may have been unnecessary, given the GSEs' broad-based appeal. Presidents, cabinet secretaries, and members of Congress liked being able to subsidize homeownership without the bother of raising taxes or increasing on-budget spending. As

the Stern School economists note, this something-for-nothing arrangement had bipartisan appeal: "On the left, [the GSEs] were vehicles for promoting affordable housing for all, while on the right they furthered the idea of the ownership society." The GSEs were not rogue operations. They anchored the housing strategies of the Clinton and George W. Bush Administrations, though the Bush Treasury also proposed tougher GSE regulation. Fannie and Freddie allowed government, it seemed, to pursue worthy public-interest goals without any apparent cost.

Conventional wisdom—as reflected in the report of the National Commission on the Causes of the Financial and Economic Crisis in the United States—has exonerated Fannie and Freddie from causing the crisis. The reasoning is straightforward. Although it's true that Fannie and Freddie's lending standards eroded, most of the weakest home mortgages were made by private lenders (Countrywide Mortgage Finance, for example) and then packaged in "private label" mortgage-backed securities (MBS) that were sold to investors. It was these loans, also placed in "collateralized debt obligations" (CDOs), that overwhelmed the financial system with "toxic securities." From 2003 to 2006, Fannie and Freddie's share of new mortgage originations declined, while private label MBSs—many crammed with risky "subprime" loans—tripled their share from 12% to 38%. Whatever Fannie and Freddie's excesses and errors, the argument goes, they became peripheral rather than central to the meltdown.

Establishing Culpability

This thesis now stands challenged. Fannie and Freddie's pernicious influence, Morgenson, Rosner, and the Stern economists contend, went well beyond the dubious loans they directly made or guaranteed. One channel, Morgenson and Rosner argue, was the demonstration effect. If the nation's biggest mortgage lenders could relax lending standards, so could everyone else. "Because Fannie was the leader in housing finance," they write, "its actions set the tone for private-sector lenders across the nation." The Stern School economists add another reason: a "race to the bottom" among mortgage lenders. Private lenders, effectively excluded from the safety of the "conforming" mortgage market, responded by "moving down the credit curve of increasingly shaky mortgage loans." As private lenders relaxed credit standards, Fannie and Freddie followed suit to recapture lost market share. Bad lending begat worse lending.

Probably no one has trumpeted this revisionist argument more than Peter Wallison, a fellow at the American Enterprise Institute and a former general counsel to the Treasury Department in the Reagan Administration, who has waged an unrelenting campaign to establish the GSEs' culpability in the financial crisis. As a member of the financial crisis commission, he wrote a 95-page dissent—not joined by the Commission's other three Republicans—contending that the "*sine qua non* of the financial crisis was U.S. government housing policy." Wallison now feels vindicated and said so in glowing reviews of *Reckless Endangerment* in the *Wall Street Journal* and *Barron's*. "Far from being a marginal player,

Fannie Mae was the source of the decline in mortgage underwriting standards that eventually brought down the financial system" he wrote in the *Journal*.

In Wallison's view, the number of risky loans attributable to the GSEs has been dramatically underestimated. He usefully notes that "subprime mortgages" lack an agreed-upon definition. These loans typically involve low down-payments—sometimes zero or even less than zero, when lenders provided more than 100% of a house's market price. Borrowers often had shaky credit histories, modest incomes, and undocumented wages and financial assets (resulting in so-called "liar loans"). But without precise criteria, says Wallison, it's easy to misclassify risky loans, and that's what happened. For years, he argues, Fannie reported subprime loans as only those purchased from self-identified "subprime" lenders. That was about 1% of Fannie's portfolio. But when judged by borrowers' low credit scores—a statistical rating based on consumers' past payment history—the volume of risky loans was much higher, according to Wallison.

Relying on a study by Edward Pinto—the chief credit officer of Fannie from 1987 to 1989 and now also at AEI—Wallison asserts that by 2008 half of all American mortgages had been made to borrowers with low credit scores. Fannie and Freddie held 12 million of these 27 million risky mortgages, with a face value of $1.8 trillion. There were 7.2 million other mortgages, valued at $900 billion, insured by either the Federal Housing Administration or the Veterans Administration, or undertaken as a result of other federal programs. That leaves 7.8 million mortgages to risky borrowers, with a face value of $1.9 trillion, held by private lenders. Thus, Wallison argues, government policies spawned the crisis.

Deciding between these rival theories about the housing market requires further economic forensic work to reconcile or discredit inconsistent numbers. Even Wallison concedes that Pinto's data haven't been subjected to a critical examination necessary to validate their accuracy. (As this essay was going to press, the Securities and Exchange Commission sued six former executives of Fannie and Freddie—three from each company—alleging that they had dramatically understated the number and amount of risky mortgages on their companies' books. From new accounts, the accusations parallel Wallison's critique. Lawyers for some of the executives responded that disclosures were adequate and that they will fight the charges.)

Panic

But this exercise isn't really necessary to understanding the broader crisis, whose hallmark was financial panic: a fear-driven rush for the exit by lenders and investors. Large financial losses don't automatically lead to financial panic. In the 1980s, the savings and loan industry—then a main source of mortgages—collapsed and was rescued by the government. This did not cause a panic. In March 2000, the stock market's "tech bubble" burst: the market ultimately fell 50%, with paper losses of $8.5 trillion, according to Wilshire Associates. *This* did not cause a panic. When the housing bubble burst, however, there was a panic. It was the panic that did the real damage, and the mortgage losses—whether inflicted by the GSEs or private lenders—were simply a catalyst for this broader breakdown.

So, we need to understand the broader breakdown. Superficially, this seems easy. Banks and investment banks had expanded their loans and investments (bonds, stocks, securities, and investments of all types) at a torrid pace. From 2003 to 2007, their assets roughly *doubled*, report the Stern School economists. Much of this was financed with short-term credit: borrowings from the commercial paper market or the "repo" market (short for "repurchase agreement"). These credits typically lasted from a few days to a year. Details are less important than the chief implication: banks and investment banks became highly vulnerable to any loss of confidence by short-term lenders. Leverage—the ratio of borrowed money to stockholders' capital—was high. For investment banks, the leverage ratio rose from 23:1 in 2003 to 31:1 in 2007, according to the Stern School economists' estimate. Banks' ratio was 13:1 in both 2003 and 2007, but this was misleading, because it excluded off-balance sheet borrowing for which banks retained some responsibility. For banks and investment banks, the absolute amounts of loans—hundreds of billions of dollars—were enormous.

In the fall of 2008, lenders—fearful of mortgage losses—panicked. Banks and investment banks that had predicated their lending practices on access to abundant amounts of cheap, short-term credit, found it difficult or impossible to function when that stream dried up. Those that could not roll over their debt went bankrupt or were swallowed by other institutions. Lehman Brothers' failure on September 15 accelerated the panic. Lenders—including large companies and money market funds—no longer knew which borrower was a good risk, so treated all of them as bad risks. This comprehensive abandonment of short-term lending, as fearful investors shifted funds into Treasury securities, threatened the financial system. Merrill Lynch and Wachovia were merged into other institutions. Only massive intervention by the Federal Reserve, which provided emergency loans, and the congressionally-created Troubled Asset Relief Program (TARP), which injected capital into banks, averted a wider collapse.

With hindsight, the mounting reliance on short-term credit that made banks and investment banks so vulnerable was insane. Yet the borrowers borrowed and the lenders lent. That they did so demonstrates, again, the optimism that was the root cause of the financial crisis. It rationalized behavior—both private decisions and government policies—that sent the economy skipping down the path toward crackup.

The mortgage debacle, whether caused by errant government policy or rapacious private action, was not freestanding. It was simply one manifestation, albeit a large one, of a climate that made foolish practices seem sensible. A broad underestimation of risk rested on self-serving assumptions. It was, for example, widely assumed that home prices would always rise, meaning that if borrowers defaulted lenders would be protected against heavy losses. This was one reason why Standard & Poor's and Moody's gave mortgage-related securities high ratings.

Faith in Progress

So we return to the original question: what caused the optimism? The main answer was faith in economic progress. We seemed to have conquered the worst economic instability. After the harsh 1981-82 recession, with unemployment reaching 10.8%, there had been only two recessions, those of 1990-91 and 2001. Both were mild and brief. Recessions that might have happened but didn't, strengthened this confidence. The Fed seemed capable of defusing broad economic or financial setbacks. It had done so after the 1997-98 Asian financial crisis, after the collapse of the hedge fund Long-term Capital Management in 1998, after the popping of the "tech bubble" in 2000. Globalization was raising living standards around the world and, despite problems, suggested a consensus favoring the free flow of goods and money.

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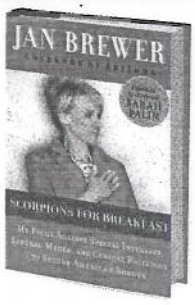

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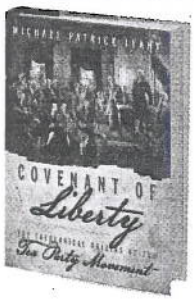

Leahy traces the roots of the Tea Party movement back to the libertarian ideas of English Leveler John Lilburne and common lawyer Edward Coke

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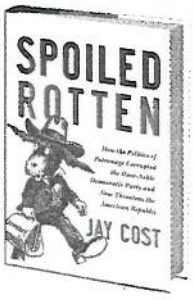

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Economic life seemed less risky. People and institutions adapted their behavior to a world that seemed to have grown safer and was likely to go on getting safer still. Households could take on more debt because the infrequency and mildness of recessions improved their ability to service the debt. Lenders could be more accommodating for similar reasons: borrowers were better bets than before. Players in financial markets could be more adventurous, because the world was less risky. They could finance their trading and investments with more short-term debt, because the dangers of borrowing too much had receded. Government regulators could relax, because financial hazards had, it seemed, retreated. In short, good times bred over-confidence and complacency. All this occurred gradually, as people absorbed the implications of their own experiences.

But the effect was magnified, I think, by a parallel development that has received too little attention in all the crisis post-mortems: the belief that the technology of finance had also reduced risk. Here, again, progress seemed to have triumphed by understanding financial risk at a level of clarity and detail never before possible. New techniques, often computer-based, improved the evaluation of risk, while new types of securities allowed investors to calibrate the amount of risk they wished to tolerate when building a portfolio.

A striking example of the new financial technology was the use of "automated underwriting systems" to approve or reject mortgage loans. For decades, the review process had been slow, cumbersome, labor-intensive, costly and—to some extent—subjective. Lenders painstakingly assembled thick folders of documents to verify borrowers' income, assets, and credit history, as well as the home's value. In the 1990s, this manual process gave way to computerized systems based on "FICO" scores—named for the Fair Isaac Corporation, a pioneer in the development of quantitatively sophisticated credit ratings that used the major credit bureaus' data on individuals' payment histories. The FICO scores had previously been used to evaluate credit card approvals and auto loans. It was probably inevitable that they would spread to mortgages.

Beyond Guesswork

In 1995, both Fannie and Freddie adopted automated underwriting systems to evaluate mortgages they were considering purchasing. Soon, they required major mortgage brokers dealing with them to use automated systems. The advantages, aside from quicker and cheaper processing, seemed obvious. Instead of "rule-of-thumb" guidelines, underwriting decisions would be based on scientifically verified trends involving millions of borrowers. Not all loan documentation was eliminated, but some borrowers "with high credit or mortgage scores" were exempted, as one 2004 study put it. Similarly, credit scores might justify "the extension of mortgage credit to some households traditionally viewed as higher risk," because past behavior had shown them to be financially responsible. Human judgment, which might encompass economic and racial bias, was being replaced by statistically valid criteria.

Another new approach, heavily used by banks and also relying on computer technology, involved so-called "value at risk" (VAR) models, which attempted to measure banks' plausible exposure to losses. Until the 1980s, banks gauged their vulnerability informally. As Gillian Tett—a columnist and editor for the *Financial Times*—writes in her book *Fool's Gold*:

> In previous decades, banks had taken an ad hoc attitude toward measuring risk. They extended loans to customers they liked, withheld them from those they did not, and tried to prevent their traders from engaging in any market activity that looked too risky, but without trying to quantify those dangers with precision. In the 1980s, though, [Bankers Trust] had developed the industry's first full-fledged system for measuring the level of credit and market risk.... That eventually prompted other bankers to start trying to measure risk not according to vague hunches but by using precise quantitative technique.

The VAR models enabled banks to go beyond guesswork; they could calculate potential losses under a variety of plausible circumstances.

As these new models emerged, financial firms were simultaneously creating new types of securities that also seemed to diminish risk. Through the 1970s, financial markets remained dominated by traditional stocks and bonds: stocks gave holders an ownership stake in companies and bonds constituted long-term loans to firms and governments. To be sure, there were some "derivatives," mainly "futures" (obligating holders to buy or sell something at a fixed date) and "options" (giving owners the right to buy or sell some other

security at a predetermined price). But they were a decidedly second-order phenomenon. This changed in the 1980s, as new financial instruments proliferated.

In 1970, the Government National Mortgage Association (Ginnie Mae)—a government agency dealing only in government-insured mortgages—created the first "mortgage-backed security," a bond-like security. The money raised by selling the MBSs was funneled into writing mortgages, while the monthly payments from the bundled-together mortgages provided a stream of principal and interest repayments to investors who bought the securities. By the 1980s, Fannie and Freddie were issuing MBSs for "conforming" mortgages. Similarly, credit cards, auto loans and commercial mortgages were "securitized." More exotic instruments also were invented: for example, "credit default swaps" (CDSs) that enabled investors to insure themselves against specific losses (say, the default of a corporate bond); and "collateralized debt obligations" (CDOs) that were bundles of other "securitizations."

Financial Engineering

By and large, these changes were viewed favorably. For starters, they broadened financial markets. Consider home mortgage lending. Until the 1980s, banks and savings and loan associations, mostly local or regional, were the dominant providers of this financial service. They made the loans, serviced them, and kept them in their portfolios. The advent of MBSs nationalized the mortgage market so that other investors (pension funds, insurance companies, wealthy individuals) could also finance housing. This shift tended to homogenize and lower interest rates, because more lenders were competing to do business with the nation's homebuyers. Similar arguments could be made for other "securitizations." Likewise, many "derivatives" allowed investors to hedge their risks. With a CDS, for example, one party pays the other what is, in effect, a premium to be protected against a possible default. If the affected bonds defaulted, the party receiving the premiums had to make good the loss.

All this "financial engineering," as it was called, seemed to strengthen the system. By creating more choices for more investors, the theory went, the new instruments spread risk more widely and caused more of it to be assumed by investors who best understood the risks. Finance's basic task—allocating a society's savings to the best investments by grasping the underlying risks—was improved. Some financial engineers felt that they were agents of intellectual and social progress. Recounting the creation of CDSs, Gillian Tett quotes one bank executive waxing euphorically: "Five years hence, commentators will look back to the birth of the credit derivatives market as a watershed development...[that] will fundamentally change the way banks... account for risk."

Although this was self-serving—handsome fees were to be earned from issuing and trading these new instruments—the enthusiasm was not confined to bankers. "When I read the details [of the CDS]," one government regulator said later, "it seemed to me that this was one of the best innovations I had ever seen. It was just a wonderful idea!" Among the believers was Federal Reserve chairman Alan Greenspan. "The use of a growing array of derivatives and the related application of more-sophisticated approaches to measuring and managing risk are key factors underpinning the greater resilience of our largest financial institutions," he said in a 2005 speech.

This was, as we now know, wishful and extremely dangerous thinking. In reality, much "financial engineering" weakened the system. Rather than dispersing and diminishing risk, it augmented risk by making the system so complicated that hardly anyone understood it. Many investors held securities—mainly but not exclusively mortgage-backed securities—whose risks they misjudged because they relied on rating agencies or underwriters. False optimism encouraged banks' and investment banks' overdependence on cheap, short-term credit: "hot money" that could flee quickly. Derivatives spawned speculative trades that, in some disastrous cases, were not hedged and—when the bets went bad—inflicted huge losses on the system. Regulators raised few warning flags because they, too, embraced the same false optimism.

Indeed, regulatory practices contributed unintentionally to the financial breakdown. In 1988, bank regulators of advanced countries adopted what's referred to as Basel 1 (named after the Swiss city where negotiations began)—rules governing banks' required capital, which acts as a buffer against losses. The standard capital requirement was 8%: a $1 million loan to a company required $80,000 of capital. Not illogically, the regulators decided that less risky investments would require less capital. In this scheme, home mortgages were judged sufficiently safe that they required only 4% capital. Later, "securitized" mortgages were judged even safer and required less

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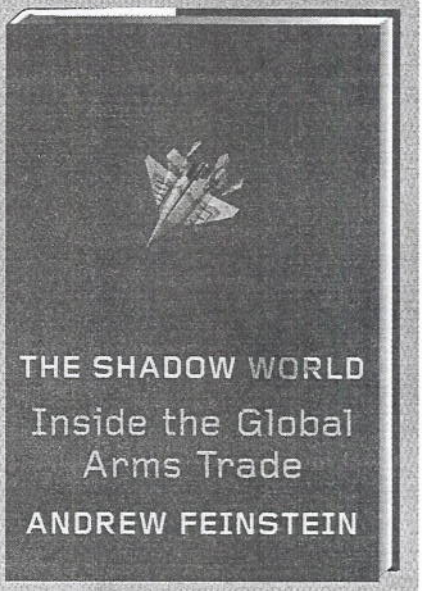

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capital. Banks seeking higher leverage were nudged to hold more mortgages, because that minimized the need for capital.

A Larger Ailment

All this reflected the faith that financial risk could now be better judged and managed. As this conceit spread, the whole system grew potentially unstable. Mortgages were a big problem but not the sole problem. If they had been the only blunder, the financial collapse would have been less disruptive—a larger version of the 1980s' savings and loan crisis. Banks' and other financial institutions' mortgage losses would have been quarantined from the rest of the financial system, just as the S&Ls' losses were. Strong institutions would have acquired weak institutions and the weakest would have closed. Government insurance would have protected depositors. No doubt, taxpayers would have absorbed other losses, including Fannie and Freddie's. But the blow to normal lending—and to overall confidence and the economy—would have been less drastic.

The actual crisis, unfortunately, was much different. As Roger Lowenstein shows in his readable and detailed account, *The End of Wall Street*, it was a systemic crisis. Faith was shaken in the largest, most respectable institutions because no one knew the value of their securities and all depended heavily on short-term credit. The misguided CDS bets of AIG, the former blue-chip insurer, threatened to spread losses to the banks and investors it had presumably insured. The collapse of some short-term credit markets, such as commercial paper loans, jeopardized the working capital of major companies. The breakdown of "securitization" deprived the housing and auto industries of routine credit and accelerated their decline in sales. Investment fell as firms hoarded cash to protect themselves against a loss of credit from banks or financial markets. Unemployment increased rapidly as employers reacted to slowing sales and rising inventories. The financial crisis engendered a broader economic crisis.

So the single-minded focus on mortgages is misleading. It was but one symptom of a larger ailment. In its final report, the Financial Crisis Inquiry Commission asserts that the crisis, "the result of human action and inaction, not of Mother Nature or computer models gone haywire," was "avoidable." It's certainly possible to create a counterfactual narrative in which the crisis doesn't occur. In this fantasy, government is more restrained in plugging home ownership; regulators intervene to stop the erosion of mortgage lending standards; tighter regulation of derivatives catches AIG's bad bets much earlier; rating agencies are more skeptical of MBSs and CDOs; banks and investment banks eschew their dangerous dependence on short-term credit.

How likely was this? Not very. Perhaps some decisions, such as the failure to rescue Lehman Brothers, made the crisis worse. But the glib conclusion that the crisis could have been entirely avoided springs from the same naïve optimism that brought us the crisis in the first place. It reflects the political nature of most post-mortems and the assumption that, if only different policies had been followed, the outcome would have been different. On paper, this may be true. But in reality, it's just a rhetorical debating point. It minimizes the complexity of what happened and ignores the way people, institutions, and entire societies learn—by experience, for better or worse.

With hindsight, the quarter-century between 1982 (when the then-harshest post-World War II recession ended) and 2007 (when the now-harshest recession began) was a period of extraordinary economic placidity. Although there were problems and setbacks—and many complaints about them—they were usually handled without large and lasting damage. People at all levels (business managers, government officials, economists, investors, ordinary workers and consumers) made increasingly optimistic assumptions about the economy, which influenced how they thought and behaved. They began to regard semi-permanent prosperity, periodically interrupted by mild slumps or passing financial scares, as the new and enduring normal.

In short, we lulled ourselves into a false sense of security. The very belief that we had entered a new era of ever diminishing risk and ever growing prosperity led to decisions by governments, investors, businesses, and consumers that augmented risk and jeopardized prosperity. The crisis that began almost four years ago, and whose destructive effects still assail us, is the price we are paying for having been wrong.

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