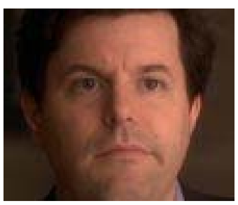
FRONTLINE

INSIDE THE MELTDOWN

Roots of the Crisis

CHARLES DUHIGG *THE NEW YORK TIMES*



Charles Duhigg

Sheila Bair

Adam Davidson

Chris Dodd

Martin Feldstein

Barney Frank

Mark Gertler

The important thing in '07 is that almost everyone who has a head on their shoulders is saying, "I think there might be a problem here." But there's one fundamental response that everyone takes faith in, which is the price of an American home has never consistently gone down since the Great Depression. ...

But here's what's happened in the meantime that not a lot of people are paying attention to. ... From 2004 to 2007, Fannie [Mae] and Freddie [Mac] are all of a sudden under assault from Wall Street. Wall Street is trying to take over Fannie and Freddie's business. And Fannie and Freddie, to compete, basically start saying, "We're going to start buying riskier and riskier loans." ...

So there's this fundamental thing that happens between '04 and '07 which is that all of a sudden, all of the data that was the ballast that supported this belief that homes will never lose any value, the underpinnings of that have disappeared. But not a lot of people have paid attention to it.

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SHEILA BAIR CHAIR, FEDERAL DEPOSIT INSURANCE CORPORATION

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For years there were bills in Congress to try to address what they called predatory lending, perhaps that was a prejorative – lax lending – but it was bad lending, whatever type of adjective you want to put on it. And they just couldn't get the political momentum to get anything done. And I think that was because everybody was making money. Even borrowers were making money if they could keep refinancing.

I think the hidden fees and costs of these loans were, to some extent, hidden from borrowers, especially subprime borrowers, where you're dealing by definition with borrowers who have limited credit experience or have had a past of troubled credit experience. ... They were still refinancing, still putting a lot of cash up. ... And there wasn't a lot of hue and cry except primarily from the consumer groups at that point. I think that was the problem. It's very, very difficult in Washington to get political will to move anything when everybody's still making a profit out of it.

And nobody was holding onto the risk. That was the other problem with the securitization markets: These loans were being pooled and broken into securities and sold off to investors. The investors actually had the long-term risk on these mortgages. They were the ones that were going to be taking losses if the mortgages didn't keep performing.

But they didn't really look at the underlying mortgages, either. They relied on rating agencies, and they didn't really look at the underlying mortgages. They just relied on mathematical models and say: "Oh, well, it's overcollateralized by 30 percent. My gosh, we couldn't have 30 percent of the mortgages going bad here, so we're going to give it a AAA rating." So nobody really looked at the human faces behind these mortgages to see if they were actually affordable and sustainable.

How could this happen?

It was a breakdown at every step of the way, and regulators included. The majority of it was done outside of insured depository institutions. But there were some banks that were doing it, too. And I think that was more in response as they were losing market share to third-party originators who were the shadow banking system – pretty much completely outside the regulatory system. They could get funding from Wall Street securitizations, and again, the risk was being passed on to investors who also weren't looking at the underlying mortgages. And borrowers, ... it was still working for them so long as the housing market was going up.

Everybody's compensation incentives, financial incentives, were short-term, not long-term. There are a lot of lessons to be learned to this, but if there's one, it's that the compensation structures, especially for the originators, needs to be tied to the long-term performance of the loan. If they can just get paid up front, sell it off, and nobody else is looking at the risk, that doesn't work. And that's really where the market breakdown occurred. ...

ADAM DAVIDSON NPR/*PLANET MONEY*

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There's sort of [four] contagions. In the old banking system, if you go back far enough, you could have a Brooklyn recession and a Queens growth period. Or you could even have a 78th Street recession and an 82nd Street growth, because the banks really were local. ...

The new system, the shadow banking system, you have this global pool of money. ... You have these mutual funds and pension funds and insurance companies, which of course are just all of our money pooled into one big fund. But you have TIAA-CREF with half a trillion dollars and Fidelity money market funds with trillions of dollars. And they don't have to make a profound decision. They don't have to sit there and go, let's bring down Japan, or let's destroy Hungary. They just get a little nervous and they say, I'm a little nervous about Hungary; let's move to a different part of Europe. ... And enough of them make the same decision at the same time, and the impact is cataclysmic. ...

So this global class of investors ... all over the world is tied; it's linked. If an investor in Switzerland is worried about Thailand and switches their money to Korea, it affects an investor in Brazil. ...

And then the other part of the contagion is the actual subprime-related assets. The other big glossary word is "leverage," which defined this bubble period so much. It's not just borrowing. If you borrow $100,000 to buy a house, that's borrowing. If you borrow $100,000 to buy a million dollars' worth of homes and then you flip them, that's leverage. You have a base of capital and you build sort of a house of cards. And what we learned is the base was built disturbingly often on these subprime structured credit products.

To understand why that spread so far, because it kind of doesn't make sense – why would banks in Switzerland and Japan and Brazil be so focused on homes owned by poor people in America? But you have to see what happened between 2000 and 2007. ... It took humankind centuries to get to $36 trillion, and then it took us six or seven years to double that. And in no time at all there's twice as much money looking for something to invest in, but there aren't twice as many businesses and factories to invest in. They had to find something new. One of the things that was growing the fastest and attracting the most investment was the subprime housing market in the U.S. And then you create these leveraged products off of it, so a billion dollars of subprime loans can support $10 billion worth of structured products. Then you create these credit default swaps on top of those. And suddenly that $10 billion that really is based on $1 billion is actually supporting $100 billion worth of investments elsewhere.

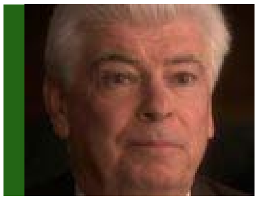
And that actually would have been OK ... if they'd seen it as long-shot bets. ... But what they did was they took this stuff and used it as the building blocks on which they built their financial empires. ... And that means that when that stuff starts breaking, just huge pillars of the financial system break as those bricks are pulled out. And that's the [second] contagion. ...

The third would be these credit default swaps and these completely opaque, confusing bets that different financial institutions made on the health of other financial institutions and other financial products. The subprime housing crisis, if that's the flu, then the credit default swaps are the sneeze that spread the flu very quickly around the world.

And then, there's a fourth contagion which is just all of this, meaning there's less money in the world, meaning there's less money to lend, meaning the real world starts firing people, laying people off, people stop buying stuff. And then there's a real-world recession, and that just makes everything else that's happening worse. ...

CHRIS DODD CHAIR, SENATE BANKING COMMITTEE (D-CONN.)

Again, there was an understanding that the residential mortgage market was the problem. And obviously,



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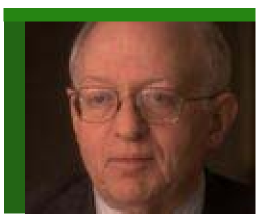
the securitization – it isn't just holding a mortgage. When I had my first mortgage, I could have gone down to my local bank for 30 years and looked at it every day. And it never left town, my mortgage. And all of a sudden, a number of years ago, the brilliant idea of securitizing, which was actually not a bad idea because it created capital to allow more people to be able to afford to buy a home, under good underwriting standards – I'm not opposed to securitization.

It was the branding of these securitized bundles as being AAA. It was luring people into mortgages they knew they couldn't afford. But the broker was out of the deal within five to six weeks; the bank was out of the deal in eight to 10. And the rating agency was out of it quickly, as soon as they put a label on it as being a highly reliable and conservative investment. And, of course, others who are looking at these things did not know what they were getting, being sold off into the marketplace globally. And obviously all of that [led to this] cascading effect, as these mortgages failed, and the markets, the capital markets seize up. ...

I speak at a high school almost every week in my state, and I always say if I could explain this to high school students, they'll understand: ... You're all taking biology. Our economic system is like our circulatory system. That capital has to flow and move around from banks. Almost every business borrows money to survive – to pay their employees, to buy their goods or their raw materials – and then they pay it back. And then they put people to work; they produce products or provide a service. And when the circulatory system gets clogged up, obviously you could have a stroke or a heart attack. And that's, in effect, what our economy is doing, a stroke or a heart attack. ...

MARTIN FELDSTEIN ECONOMIST, HARVARD UNIVERSITY



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I thought, and spoke about it at a Federal Reserve conference in the summer of 2007, that this combination of credit default swaps on mortgage-backed securities, that all of this was a potentially very, very dangerous combination; that the decline in house prices that had begun in the summer of 2006 was because of these mortgage-backed securities and because of the derivatives based on these mortgage-backed securities, that this could do tremendous damage to the balance sheets of financial institutions.

You knew how broad the problem was? ...

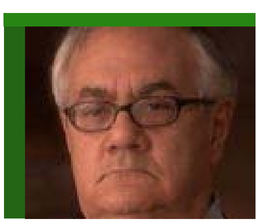
Yes. Once you understood that that was out there, then you had a pretty good idea that this was a very serious problem, and that as house prices came down, we would see more mortgages becoming greater than the value of the house; we'd see more people with less equity in the house, with negative equity in their homes, meaning their loans would be greater than the value of the house, and that that would cause very serious problems. ...

Things are happening with the banks around then, too, yes? There's a kind of credit crisis starting?

... The credit crisis in the banks, the unwillingness to lend to each other and to others, really reflected the fact that there was a lack of confidence on the part of the banks in the creditworthiness of other financial institutions. And why? Because everybody knew that everybody else had these mortgage-backed securities and fancy derivatives based on these mortgage-backed securities. They didn't know how much, but what they knew was that those things were not worth what they claimed to be on paper, and therefore the danger was that another institution to which you lent wasn't going to be able to pay you back. ...

So the easiest thing for a financial institution was to say: "Thanks, but no thanks. I don't want to lend to other financial institutions." So our credit markets really froze up, and lending stopped.

BARNEY FRANK CHAIR, HOUSE FINANCIAL SERVICES COMMITTEE (D-MASS.)



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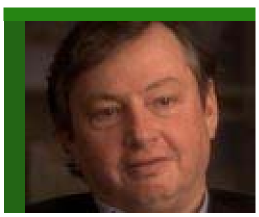
I would say in 2004-2005 you began to see a pattern of subprime mortgage failures. I don't remember it exactly. I do know that in 2004, when the Bush administration ordered Fannie Mae [Federal National Mortgage Association] and Freddie Mac [Federal Home Mortgage Corp.] to increase the number of mortgages they bought from people below the median income, I complained and said, "Look, you are going to jeopardize them, and you are going to push people into mortgages [they] can't afford."

I do remember very clearly, by 2005, several members of the

Committee on Financial Services – again, the Republicans were in the majority during this point – two from North Carolina, where there has been real leadership on this, [Democratic Reps.] Mel Watt and Brad Miller, and myself, working with the Republican Spencer Baucus [R-Ala.], started to see if we could draft the legislation to restrict bad subprime mortgages. A couple of others were trying to do this, too, [Reps.] Paul Kanjorski [D-Pa.] and Ed Royce [R-Calif.].

So by 2005 there was a recognition that too many bad mortgages were being issued, and we were trying to work something out. And then [Texas Rep.] Tom DeLay, as the Republican leader, sent word to [Rep.] Mike Oxley [R-Ohio], the chairman of the committee: "Stop it. You are not going to get any bill up." ... First we tried to push Greenspan to use the authority, and he wouldn't do it. And secondly, we then tried to draft a bill, and Tom DeLay said no. ... If we had been able to stop it in 2005, we would have diminished this crisis.

MARK GERTLER ECONOMIST, NEW YORK UNIVERSITY



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In my view, where things got out of hand is there was a failure to adjust the regulatory system. You could go along the way and say, look, if we had not permitted subprime lending, if we had not permitted these financial institutions that weren't banks to basically adopt portfolios like banks, holding mortgages and issuing short-term liabilities, we would not be in the mess we are today.

How did the regulators miss the regulation?

Unfortunately, I think it always takes a crisis to get change. In the late 1980s, we had a banking crisis. ... The commercial banks went into risky commercial real estate lending and took losses. The crisis generated support for regulatory reform, and we had the Basel capital requirements phased in, and these banks were required to hold more capital, and in fact they did raise their capital base. So there's a case where crisis leads to reform. Reform, at least for a while, sets you on the right track.

But then, as happens throughout history, financial institutions [learn] how to game the system. So banks, instead of initiating and holding mortgages, which would require them to have capital against these mortgages, would initiate them and sell them. The securitization market had been growing, so here was a new type of loan. You could securitize mortgages.

Also, along the way, there was a growing belief that everybody should have access to home ownership. That was politically appealing to both Republicans and Democrats. So there was an easing of standards, and these subprime loans were securitized. There were people who did ring warning bells about this, but again, when the economy is going well, it's difficult to get change.

And I would add one more factor to the brew. Since 1984, the U.S. economy had performed reasonably well – the two recessions, but both very mild, relative price stability. There wasn't the sense of urgency to bring change, even though some people did see that the regulatory system wasn't right.

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