The Social Life of a Financial Crisis

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1 I am anxious to acknowledge and express gratitude for contributions to this piece in previous forms to Timothy J. Sinclair and David Talbott.
This paper will argue that six, entrenched, intersubjectively shared expectations of market actors caught up in the financial crisis of 2008 were systematically knocked down by events, and their disappointment in the demolition of these shared beliefs is central to explaining their behavior prior to and during the crisis. The six shared expectatoins follow:

(1) The Efficient Markets Hypothesis (EMH) explains the pricing and behavior of asset markets; (2) The U.S. housing market may suffer regional declines, but will not fall in tandem nationwide; (3) Market risk has been obviated by counterparty surveillance, value-at-risk modeling and by securitization which “slices and dices” risk and apportions it to those market actors best equipped to bear it; (4) When the credit rating agencies rate a security AAA, there is no default risk; (5) The financial counterparties you face today will remain solvent and face you tomorrow; and (6) The U.S. Government will never permit a major, systemically important financial institution to fail. They will provide public funds to bail it out or arrange a private rescue through a subsidized sale of the firm. By the time the sixth and final shared expectation regarding the stability of the institutional and policy environment in which they were operating was demolished with the US Treasury and US Federal Reserve’s blithe inaction as a major investment bank failed, the financial markets seized up and quit functioning entirely for some asset classes.

**Intersubjective Expectations of Market Actors:**

The market malfunctions that followed all have their origins in the intersubjective expectations of market actors who are looking to one another for signals about appropriate market behavior, rather than calculating utilities in accordance with “rational expectations” that they assess independently of the shared social and economic understandings that they derive from one another. Put most simply, it is intersubjective expectations rather than rational expectations *per se* that generate stable transactions between market actors. They
look to one another for signals to inform their own market transactions. Markets react adversely against information and signals (such as signals from the central bank) that are contrary to the intersubjective expectations of market actors.

Not only are the expectations that coordinate market behavior based upon intersubjectively shared social understandings, these intersubjective expectations have constitutive effects, per Alexander Wendt’s lexicon (1999, 88). Wendt delineates constitutive from causal effects and argues that “[i]deas or social structure have constitutive effects when they create phenomena – properties, powers, dispositions, meaning, etc. – that are conceptually or logically dependent on those ideas or structures that exist only ‘in virtue of’ them.” (ibid.) Because market actors so often act on the basis of the “truth” of their intersubjective understandings and expectations, what the markets anticipate on the basis of these expectations is indeed constituted in acting on these shared expectations. Market stability then relies upon intersubjectively shared understandings among market actors regarding economic cause and effect, and the stability of the institutional environment within which markets function, and it collapses when expectations based upon shared understandings are disappointed (Hall 2008, 197ff).

We see countless examples of the reliance on intersubjectively shared understandings deployed in the literature on economics to explain how the behavior of market participants diverges (frequently) from the behaviors predicted by rational expectations theory. Shared understandings of market actors have a causal effect on market behavior, generating market behavior that can be quite unrelated to rational analysis of the “fundamentals” of the “real economy.” Markets participants rely on “confidence” in intersubjectively shared understandings that the present is understood and the future may be predicted. This is how “manias” or “booms” or “asset bubbles” so quickly become “panics”, “crashes”, or “busts”. A rising tide of intersubjectively shared, but wholly irrational expectations about future
rewards can carry along investors, who often rely upon one another for signals, rather than fundamental cost/benefit or risk/reward analysis of their own, to guide their investment decisions. Changing expectations generate major market reversals. Had the earlier expectations that generated the mania or bubble been based upon “rational expectations” no “market correction” would be required or observed.

**The Expecation of Efficient Markets:**

No small part of the difficulty in which we presently find ourselves may be traced to the belief by actors in the financial markets, and by central bankers with supervisory responsibility for the financial system, that financial markets behave in accordance with the Efficient Markets Hypothesis (EMH) of neoclassical economics. In accordance with this hypothesis, markets always clear at the “equilibrium price” which constitutes the normal optimal state. The prices of commodities and assets are always and everywhere the “correct” price that constitutes equilibrium between demand and supply. A continuous stream of new information regarding changing supply and demand functions govern price movements of these commodities and assets, and only an “external shock” will move asset prices away from the equilibrium clearing price that is the “correct” price determined by perfect information about supply of and demand for the commodity of asset in the marketplace. Market participants when interviewed in the press never tire of talking about what “Mr. Market” is telling us with the latest gyration in equities prices, for example.

The EMH effectively tells us that asset bubbles cannot form in efficient markets, and ostensibly financial crises should not occur. But it is not by accident that the economic historian Charles P. Kindleberger ended his classic history of financial crises with the admonition that ‘[d]ismissing financial crisis on the grounds that bubbles and bust cannot take place because that would imply irrationality is to ignore a condition for the sake of a
theory.” (Kindleberger 2000, 231). Yet clearly nearly every financial asset class was
mispriced and in bubble territory, and then over a course of roughly a year from 2007 to 2008
quite dramatically and violently re-priced. Real estate, all forms of asset backed commercial
paper – especially RMBS (Residential Mortgage Backed Securities) and CDOs
(Collateralized Debt Obligations), to be followed by equities, corporate bonds. At the peak
of the selling, only cash and “near-monies” like US Government bonds were coveted, as
banks, financial institutions and investors hoarded cash. All of these assets were quickly and
brutally, according to financial consultant Andrew Smithers “revalued.” (Smithers 2009)

We can see that there is no place for asset price bubbles in efficient, self-regulating
markets. However, rather than demonstrate that what is true of markets for consumables in
which supply and prices responding to demand signals is also true of “factors of production”,
Samuelson has only asserted it, without demonstration. In fact, “frequently in asset markets,
demand does not stimulate supply, rather a lack of supply stimulates demand.” (Cooper 2008: 8)
It is precisely the “scarcity value” of and Samuelson’s “factors of production”, and the
occasions in which supply, particularly of “land” and “money” (property, and financial
assets), cannot be increased sufficiently to meet demand, that is responsible for the bids for
these assets. It is the expectation that scarcity will induce higher bids in the future for the
same scarce assets, that induces speculative market bids for them. So long as market actors
believe that future prices for these assets can consequently only rise, and never fall, they have
an inducement to bid up the prices of these assets into destructive asset bubbles.

I performed semi-structured elite research interviews with financial professionals who
were directly involved with the crisis, largely in New York and London, from the Autumn of
2009 to the Autumn of 2011. I’ve interviewed over 40 people, and finally have obtained
transcription of nearly all of the interviews, so I am swimming in interview data, and provide only some preliminary findings with a handful of interviews in this article.

In my interviews with financial market professionals, I was strangely able to find much faith in the EMH among them. In my discussions with investment banker, when asked wither the notion of efficient markets was an operating social fact among market participants, he pointed out that there is an entire industry that is premised on finding and exploiting market inefficiencies. “Everybody who is in a hedge fund is trained in all this math but he is doing what he is doing because he believes that markets are not efficient.” (Shafer interview)

Other investment bankers blamed the inefficiencies on the downgrades of RBMS by the credit rating agencies. Peter Wirth and Keefe, Bruyette & Woods argued that:

I think there are any number of inefficiencies or there are structural kind of constructs that can create inefficiencies like -- the prudent man rule -- which kind of encourages on the part of large pension funds, which are major investors, kind of encourages herd mentality. I mean, there are a lot of rules that are kind of procyclical and kind of almost dis-encourage contrary opinions or kind of thinking -- people thinking for themselves. That's one of them that certain investments are allowed and certain investments aren't allowed, and certain investments are allowed because other people make the investments. -- if you have a critical mass of people making a certain type of investment; you can make that kind of investment, but you might not be able to make other type. So I think that kind of distorts the capital flow.

The other that I can think of right off the bat, is the -- the ratings agencies. And the backward looking models that they had and they have and they have and parts of it are -- they also had a model that accelerated the problems when you started to have destabilization. There weren't a lot of forces that countered -- destabilized -- that countered the cycle one way or another. …And you know, when -- once something starts tipping or oscillating in terms of volatility, that component of it starts to -- be a driver behind a lot of downgrades. So once you start having a lot of downgrades, certain people can’t hold the debt anymore and they have to start selling. You know, so you get -- you kind of get a procyclical kind of force, which I’m not sure is an efficient exit. (Peter Wirth and Andrew Senchak interview)

Essentially, a herd mentality and forced selling due to ratings downgrades are here argued to generate inefficient distortions in capital allocations and inefficient exits from investment positions. As do what Mr. Wirth and Dr. Senchak refer to as “non-market” actors like the
CRAs and the Federal Reserve who in their words “don’t have skin in the game.” (Ibid.)

During the course of the dual interview Dr. Senchak appeared to try to convince himself that all the sharp pencils he had working for him made the market efficient, to wit:

…when I first came here, I saw the research department, our research department and its relationship to the trading docks. So I answered the question for myself. Oh, this is what makes the market efficient. All these people in research looking at all this information and offering their understanding of that information to the traders and the traders make decisions about whether to buy or sell. And I said, okay, this is how the information gets processed. This is what makes the market -- there has to be something that makes the market efficient, right? Or more efficient or less efficient. And it was like -- just -- it’s like human resources. (Ibid.)

Yet when the conversation revealed that adherents to the EMH don’t have any room in their belief system for asset bubbles, Dr. Senchak playfully mocked the notion and suggested, tongue-in-cheek, “if I were Fama, I would say, well -- I would have a graduate student work on the problem, why are bubbles necessary for efficient markets?” (Ibid.) The teleology implicit in the EMH is not lost on market participants any more than academics.

So another unfortunate aspect of the EMH is that it asserts as a corollary the impossibility of asset bubbles. (Cooper 2008, 30) The sudden and dramatic nationwide plunge in housing prices that began in 2007, after peaking in April 2006, (FCIC 2011) brought to the financial markets unequivocal evidence that the housing rise had been an enormous asset bubble of the first magnitude. By the time Lehman Brothers failed, market actors would be faced with a collapse of asset prices across asset classes, and further quite painful evidence that financial assets, and particularly risk assets, had been systemically mispriced for a number of years. A collapse of market prices - not only for complex RMBS and CDO securities built upon failed subprime mortgages, but the attendant collapse of prices for equities, debt instruments of all types except U.S. Government securities, Real Estate Investment Trusts, Asset Backed Commercial Paper (ABCP), and the seizure of the interbank loan and Repo markets - may be seen, in part, as a proxy for the attendant collapse of faith in
the EMH. Sudden and dramatic uncertainty of the value of any financial asset after the failure of Lehman Brothers was an unprecedented renunciation of the EMH hypothesis. But more than a loss of faith in the EMH was required to generate such a dramatic outcome, as we shall see.

**The Expectation of no Nationwide Housing Price Decline:**

The nationwide collapse in housing prices is well documented by others (see e.g. Shiller 2008). In December 2011, the national composite Case-Schiller housing price index fell another 3.8% in the fourth quarter alone, and was down 33.8% from its April 2006 peak! Mortgage delinquency in the subprime market rose to 40% by the end of 2009. (FCIC 2011) The intersubjectively shared market expectation upon which a major financing bubble had been predicated, as well as the models of credit rating agencies rating structured RMBS – namely that a national coordinated decline in housing prices was not possible – collapsed suddenly and with enormous consequence for other intersubjectively shared expectations that had propped up what remained of market confidence prior to Lehman’s failure.

Rajan has recently argued persuasively how failures of U.S. social policy generated an increasingly steep educational gap, engendering a rising income inequality within the U.S. public. (Rajan 2010: 210300) The response of the political classes to the anxiety of those at the middle and lower income scales, whose real wages have been either stagnating or falling over the past three decades was a policy of “let them eat credit”. The U.S. Congress, and successive U.S. administrations, sponsored policies for cheaper housing and consumer credit to be extended to ever lower income strata of society through a variety of programs and mechanisms. The political benefits of these policies were enormous, and the costs seemed low, for quite a long time. But a number of analysts have illustrated how ultimately the costs were enormous, because these policies resulted in “government regulatory and political
pressure, to force banks and other government-regulated or controlled private entities to reduce lending standards [in underwriting of mortgages in the U.S.].” (Wallison 2009: 365-6)

The Community Reinvestment Act and Amendments:

Key policies that ultimately led to the reduction in underwriting standards among mortgage originators were the Community Reinvestment Act (CRA) originally adopted in 1977 and subsequently amended, and the affordable housing “mission” that both the Clinton and Bush administrations encouraged, along with Congress, imposed on the government sponsored enterprises (GSEs), Fannie Mae and Freddie Mac. The original act threatened banks with denials of mergers and acquisitions approval if they did not demonstrate attempts to increase their lending to traditionally “underserved” communities. Yet it did not include provisions to second-guess the prudential examination of creditworthiness of applicants, leaving these to the judgement of banks and other loan originators. This discretion was slowly but quite definitively withdrawn by subsequent policy amendments. Clinton administration efforts to advance its 1995 “national home ownership strategy” increased pressure on lenders as Housing and Urban Development (HUD) regulators generated new rules to assess whether a bank was meeting the standards of the CRA, and threatening substantial fines for failure to comply in the view of HUD regulators. (Rajan 2010: 36-7)

The new rules took a good deal of discretion out of the hands of banks to apply their preferred lending standards, requiring them to prove “and even-handed distribution of loans across LMI [low and moderate income] and non-LMI areas and borrowers”. (Hossain 2009: 367) Equity of outcome was now required in lieu of equity of process. Lending increased to LMI borrowers. (Bhutta 2008: 61) Lending standards deteriorated significantly appearing as “innovative and flexible” products to meet the credit needs of LMI borrowers.
The amount of CRA lending in itself, of course, was not sufficient to generate a financial crisis through defaults. But CRA did generate large losses for banks, and the effort to relax underwriting standards was spearheaded by the HUD at the behest of the Clinton administration in its call for “financing strategies, fuelled by the creativity and resources of the private and public sector” (Rajan 2010: 36) to help people buy homes who could not afford monthly payments at market rates. Wallison argues that “once these standards were relaxed – particularly by allowing loan-to-value (LTV) rations higher than the 80 percent that had previously been the norm – they spread rapidly to the prime market and to the subprime markets, where loans were made by lenders other than FDIC insured banks.” (Wallison 2009: 368)

Further pressure was brought to bear on lending standards by the Clinton administration in 2000 when it “dramatically cut the minimum down payment required for borrowers to qualify for an FHA [Federal Housing Administration] guarantee to 3 percent, increased the maximum size of mortgage it would guarantee, and halved the premiums it charged borrowers for the guarantee. All these actions set the stage for a boom in low-income housing construction and lending.” (Rajan 2010: 37) Wallison cites data published by the Joint Center for Housing Studies at Harvard that demonstrated “the share of all mortgage originations that were made up of conventional / conforming mortgages (that is, the twenty percent down, thirty year fixed rate mortgage that had always been the mainstay of the U.S. mortgage market) fell from 57.1 percent in 2001 to 22.1 percent in 2006. Correspondingly, subprime loans (defined here as loans made to borrowers with blemished credit) rose from 7.2 percent to 18.8 percent, and Alt-A loans (defined as those made to speculative buyers or to buyers without the usual underwriting standards) rose from 2.5 percent to 13.9 percent.” (Ibid.: 369)
It’s worth noting, while analysts such as Wallison appear rather partisan, appearing to wish to lay all of this failed policy at the feet of Democratic administrations, Rajan reminds us that the Republican administration of George W. Bush fully endorsed this policy, and a huge role for the GSEs in implementing it, with their emphasis on “the ownership society”. He quotes a 2002 speech to HUD in this context, were Bush, with his customary “eloquence” said:

*And I’m proud to report that Fannie Mae has heard the call and, as I understand, it’s about $440 billion over a period of time. They’ve used their influence to create that much capital available for the type of home buyer we’re talking about here. It’s in their charter; it now needs to be implemented. Freddie Mac is interested in helping. I appreciate both of those agencies providing the underpinnings of good capital”*

It is the Bush administration that presided over the catastrophic boom in in subprime lending in the 2005 to 2007 period, when the amount of capital lent to borrowers of dodgy credit worthiness was at its maniacal height, and the quality of loan origination had fallen to its worst.

**The Government Sponsored Enterprises and Congress:**

Would but had the GSEs provided the underpinnings of good capital. Wallison and Calomiris provide us with a sordid tale of how the GSEs were induced, for fear of Congressional regulation limiting their privileged capacity to borrow funds at rates only slightly above U.S. Treasury rates, to take on $1 trillion in subprime loans between 2005 and 2007 alone, (Wallison and Calomiris 2009) amounting to 40 percent of their total mortgage purchases. (Wallison 2009: 370) An accounting scandal in 2003 left the GSEs vulnerable to
new legislation that might have ended their privileges, and their profitability. The GSEs were privately owned, while enjoying an implicit U.S. government guarantee of their portfolio of loans and residential mortgage backed securities (RMBSs).

As early as 1991, Congress had begun a process of developing a previously absent regulatory regime for the GSEs, and added a “mission” to support provision of affordable housing in the United States as it created a dedicated regulator for the GSEs in the Office of Federal Housing Enterprise Oversight (OFHEO), which was funded by congressional appropriations, allowing the GSEs to control their regulator through the key lawmakers who held the OFHEO’s purse strings”. (Ibid.: 72) Benefits to members of Congress included over $14.6 million in campaign contributions by GSEs and their employees in the 2000 and 2008 election cycles, “partnership offices” in the districts of key lawmakers, often staffed by relatives of members of Congress, and trillions of dollars of mortgage and home equity lending to their constituents. (Ibid.: 73)

The GSEs, of course, retained their privileged borrowing status and implicit government backing, provided they renewed their commitment to support “affordable housing” in a big way. This new tacit understanding was articulated in a Congressional hearing in 2003 when “Representative Barney Frank, later the chairman of the House Financial Services Committee, referred to an ‘arrangement’ between Congress and the GSEs that tracks rather explicitly what actually happened: ‘Fannie and Freddie have played a very useful role in helping to make housing more affordable, both in general through leveraging the mortgage market, and in particular they have a mission that this Congress has given them in return for some of the arrangements which are of some benefit to them to focus on affordable housing’”. (Ibid.: 75)
It had taken until 1997 for Fannie Mae to begin buying 97 percent LTV mortgages and until 2001 to purchase mortgages with no down payment. However, “by 2007 Fannie and Freddie were required to demonstrate that 55 percent of their mortgage purchases were LMI. Moreover, 38 percent of all purchases had to be from underserved areas (usually in inner cities), and 25 percent had to be purchases of loans that had been made to low-income and very-low-income borrowers.” (Wallison 2009: 370) Given the subsequent default rates, it’s not unreasonable to argue that the subsequent financial collapse of the GSEs appeared to be U.S. government policy.

Accordingly, subprime and Alt-A loans purchased by the GSEs rose from $85 billion in 1997 to $446 billion in 2004 and hovered between $300 billion and $400 billion a year until 2007, such that on average, accounted for 54 percent of the total market for those years, and 70 percent of the total market in 2007. (Rajan 2010: 38) Rajan cites Edward Pinto, the former chief credit officer at FHA, who “estimates that in June 2008, the mortgage giants [GSEs], the FHA, and various other government programs were exposed to about $2.7 trillion in subprime and Alt-A loans, approximately 59 percent of total loans to these categories. It is very difficult to reach any other conclusion that this was a market driven largely by government, or government influenced money.” (Ibid.: emphasis added)

If this $2.7 trillion was 59 percent of this market, in the hands of the FHA or the GSEs, then the other 41 percent, another $1.9 trillion, was purchased by private sector actors. As a consequence, the GSEs took market share from private-label issuers and generated a much greater demand for these dodgy loans from private mortgage broker and originators, driving up their market value, reducing risk premiums for underwriting them, to be purchased for securitization, by both the GSEs and private investment banks. (Wallison 2009: 371) The creation of a huge market in junk mortgage loans got a huge lift from U.S. government
housing policy. Wallison and Calomiris draw upon GSE data to demonstrate that the vast majority of mortgage purchases by the GSEs had one or more subprime characteristics between 2005 and 2007, summarized in the table below.

**Subprime Characteristics of Mortgages Acquired by Fannie Mae and Freddie Mac, 2005-2007**

<table>
<thead>
<tr>
<th>Subprime Characteristic</th>
<th>Fannie Mae (percent)</th>
<th>Freddie Mac (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Negative amortization (option ARMs)</td>
<td>62.2</td>
<td>72</td>
</tr>
<tr>
<td>Interest-only</td>
<td>83.8</td>
<td>90</td>
</tr>
<tr>
<td>FICO scores less than 620(^2)</td>
<td>57.5</td>
<td>61</td>
</tr>
<tr>
<td>Loan-to-value ratios greater than 90</td>
<td>62.0</td>
<td>58</td>
</tr>
<tr>
<td>Alt-A</td>
<td>73.0</td>
<td>78</td>
</tr>
</tbody>
</table>

*Source: Wallison and Calomiris 2009, 77. They cite data from the websites of the GSEs themselves, posted August 2008.*

A general decline in underwriting standards is evident. Conventional loans fell from 78.8 percent of all mortgages in 2003 to 50.1 percent by the end of 2006 while subprime and Alt-A mortgages increased from 10.1 percent to 32.7 percent of all mortgages issued, with the remainder on non-conventional mortgages in the form of home-equity loans and FHA or Veterans Administration (VA) loans. (Wallison 2009: 371) With the GSE’s purchasing and securitizing 59 percent of the dodgy loans by the end of this period, in response to Congressional, FHA and HUD pressure, it’s clear that the decline in underwriting standards

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\(^2\) This individual credit score is even lower than the 660 that federal bank regulators would consider to be subprime.
was transmitted to mortgage initiators and private-label issuers of subprime RBMSs by the GSE demand for such loans.

Certainly the private sector hopped on board, and in the words of former Citigroup chief, Chuck Prince, “danced” while the music was still playing. But the market for subprime mortgages was a very small and highly specialized affair prior to the huge ramp-up in GSE demand for them. Wallison argues, “The gradual decline in lending standards that began with the revised CRA regulations in 1991, and that continued with the GSEs’ attempts to show Congress that they were meeting their affordable housing mission, had come to dominate mortgage lending in the United States.” (Wallison 2009: 371) Whatever Wallison’s politics, or his motives for pointing this out, clearly they had come to dominate lending. Much has been written about the role of the financial industry in abetting and profiting from this tragedy, and I have written about it (Hall 2009[a] and Hall 2009 [b]), and shall quite a lot more in future. But as former IMF Chief Economist Raghuram Rajam proposes rather modestly, “to ignore the role played by politicians, the government, and the quasi-government agencies is to ignore the elephant in the room.” (Rajan 2010: 42)

**The Expectation that Market Risk Obviated by New Technologies:**

Clearly another intersubjectively shared expectation that market risk had been tamed also collapsed in response to the collapse in the market for RMBS and CDOs derived from mis-rated structured finance products. Value at risk (VaR) modeling was supposed to provide risk estimates on potential daily losses at a 95 percentile quality. It failed utterly to warn of the real risks to the balance sheets of banks and investment firms. The Chief Financial Officer of Goldman Sachs, for example, reported that in the credit markets “We were seeing things that were 25 standard deviation moves several days in a row.” (Larsen
2007). With the probability of a single 25 standard deviation move calculated at one in ten to the 137th power, we can charitably conclude that the claims of VaR were not substantiated by its performance. Risk may have been “sliced and diced” but it ended up on nearly everyone’s books in solvency-threatening quantities. Investment banks found themselves caught with rapidly depreciating RMBS assets and tranches of CDOs they had constructed and became unable to sell on their books, requiring the forced sale of Bear Stearns and Merrill Lynch, and the bailout of Citigroup.

My interview with Mr. Jeffrey Schafer, then Vice Chairman of the Global Banking Group at Citigroup makes clear that post-crisis Citi management clearly felt down by the VaR exercise. We discussed the assumptions of macroeconomists before the crisis of why volatility was not going to be an issue in the markets anymore due to a “global savings glut” or a “great moderation.”

**Jeffrey Shafer:** Low inflation and therefore lower volatility, you know, everybody that -- the uncertainty …in the past and so forth had gone away, and therefore, you know, the volatility as measured by the VIX or all kinds of other things had gone down and you didn't have to worry as much about risk because prices weren't going to bounce around on you anymore.

This led directly into a discussion about the failure to manage risk and of the tools designed to do so.

**Jeffrey Shafer:** I was always a bit skeptical about that piece but people talked themselves into a view of the world in which the days of big disruptions were past for the country like the U.S. or the Euro areas and something like that. And within that environment, at the same time, you had, driven by the techs in the business school, an elaboration of mathematical quantitative approach to finance that I think everybody knew was imperfect. One of the things I've learned -- too late, to be a good academic -- is that the greatest steps forwards in intellectual thought are imperfect.

But this quantitative approach was extremely -- it threw most of the data out the window, right, you are not looking at the world, you are not looking at macro developments, you're not looking at political developments, you are just running your mean variance models and calculating VaRs and that was the whole answer. And that was only for part of the process, but nobody was looking sort of for what's not in the models. And everybody -- the guys who were doing this stuff knew that everything
wasn’t in the models. But the MBAs they grind out thought they will have the whole truth there, right? And then we go off and apply this stuff. (Shafer interview)

The insurance giant AIG was brought down by having written Credit Default Swaps (CDS) as insurance against default of these products, and required a bailout in the tens of billions due to the high default rates. An absence of transparency regarding whom held which assets or contracts on whose balance sheet rendered it impossible to assess counterparty risk, calling into question the solvency of counterparties well before the Lehman Brothers bankruptcy. Consequently the markets for Asset Backed Commercial Paper (ABCP) began to dry up. And firms that were dependent on short term financing in the Repo market found these markets drying up, and finance increasingly unavailable, as their counterparties increasingly refused ABCP, RMBS securities and CDO securities structured from these alike as collateral.

The ensuing liquidity crunch dried up funding for Bear Stearns by March 2008, resulting in Bear’s shotgun fire sale to Morgan Stanley, after the government took the toxic assets off Bear’s books. (Sorkin 2009, Tett 2009) Mark-to-market accounting forced a market price well below intrinsic value for RMBS and other securities onto the books of all firms holding these securities. When people began to doubt Bear’s liquidity, and ability to repay short term obligations, they stopped “taking their name” (in the lingo of the business they stopped doing trades with Bear). As one Senior Managing Director specializing in Credit and Economics research with a large wealth management fund told me. “Well, that’s what happened with Bear liquidity dried up. People didn’t want to -- they didn’t want to do the trades anymore. And that’s what happened in Lehman… it’s that liquidity, you get into that death spiral that it’s very hard to get out of. (MacDonald interview) Bear’s access to repo short term financing dried up with critical consequences for the firm.
Suddenly the shared expectation that one’s counterparties will be around tomorrow to trade with seemed highly dubious. As this expectation collapsed, liquidity began to be hoarded, counterparties treated as suspect, and interbank and inter-firm lending ground to a halt. This began with Bear Stearns, which had invested a great deal of money in largely illiquid RMBS assets, highly leveraged by very short term loan, from other financial institutions through the repo markets. A crisis of confidence in counter-parties emerged, and generated a brutal crisis in liquidity for those newly suspect. For many of these, and particularly Lehman Brothers, this became a crisis of solvency.

**The Expectation that AAA Ratings Mean Zero Default Risk:**

Securitization was initially developed as a means to permit firms (and governments) with higher levels of creditworthiness to access capital markets to meet their borrowing needs at lower costs than those who are less creditworthy. Intermediated lending by banks (who acted as intermediaries between savers and borrowers) was replaced with disintermediated lending, whereby firms (and governments, and municipalities) approached investment houses who underwrote the debt and issued it as bonds for sale to bond market participants, whose bids (reflecting the risk premiums they would charge) largely determined the ultimate cost of capital to borrowers. This worked well in that the cost of capital to creditworthy borrowers was lowered, and the financial risk of default was ostensibly born by those who could afford the risk. Ultimately, it permitted the wave of leverage building over decades of asymmetric monetary policy to be granted the status of a high grade security, rather than an atrocious, obvious risk of default.

The Credit Rating Agencies (CRAs - the U.S. based duopoly of Moody’s and Standard and Poors, recently joined by Fitch’s, the subsidiary of the French headquartered
firm, Fimalac, S.A) were assigned the task of grading that risk. This system was the private sector solution to monitoring the risk of insolvency. Coupled to standards setting fora in international organisations, such as the International Organisation of Securities Commissions (IOSC) to, the Basel Committee on Banking Supervision, which has set capital adequacy and liquidity requirements for financial institutions and discuss supervisory control assessments of banking systems and controls and risk management structures, and the Financial Stability Forum (FSF) developed as an informal forum for cross-border regulatory issues, this system of publicly recognized, private creditworthiness assessments provided by the CRAs, was largely expected to provide the information and transparency required to permit private market actors to employ market discipline, to safeguard against systemic financial risk. The creation of complex Structured Investment Vehicles (SIVs) and Collateralized Debt Obligations (CDOs) backed in many instances by subprime mortgages (securities tranches backed by the mortgage income streams of borrowers of variable creditworthiness) was supposed to tranche out the riskiest levels of debt securities at highest risk of default to those most able and best placed to manage the risk.

Unfortunately, these tranches were rated very highly by the CRAs, who many have argued helped to design them, but which these firms themselves deny. Tranches rated AAA by the ratings agencies should have been highly unlikely to default, and protected by lower rated tranches below them, which would be expected to suffer higher rates of default. The assumption that the prices of the homes underlying the higher rated tranches would not fall, however, proved baseless. Financial officers of commercial banks, investment banks, pension funds, and insurance companies around the globe took the ratings provided by the CRAs at face value, and incapable of assessing the risk themselves, excused themselves from their fiduciary responsibilities to their clients and shareholders to engage in due diligence in assessing the level of risk of the securities they were purchasing for their portfolios.
The AAA rated tranches of these securities were in theory to be protected by the process of subordination of the mezzanine and junior tranches below them. The lower tranches held the highest default risk, as the finite income stream from the pool or mortgages securitised into these bond tranches would flow first to the “super-senior” and “senior” tranches, with losses from the income stream suffered first by the junior tranches, then the mezzanine tranches. The super-senior and senior tranches were invariably rated AAA by the ratings agencies. The rating agencies AAA ratings for these more senior tranches was likely entirely reasonable given their assumptions, which included reasonable and historical underwriting standards for loan origination for the majority of the mortgages in the pool from which these securities were synthesized. However, as we have just seen, underwriting standards had declined abysmally throughout the industry, and were at their worst in the period 2005-2007, during the GSEs trillion dollar junk mortgage buying spree.

It is precisely during this period that the GSEs were the biggest buyers of the AAA rated tranches of these - at this time - largely subprime pools of securitized mortgages. As Wallison and Calomiris (2009: 78) suggest:

“Without their commitment to purchase the AAA tranches of these securitizations, it is unlikely that the pools could have been formed and marketed around the world. Accordingly, not only did the GSEs destroy their own financial condition with their excessive purchases of subprime loans in the three-year period from 2005 to 2007, but they also played a major role in weakening or destroying the solvency and stability of other financial institutions and investors in the United States and abroad”.

Unfortunately, the assumptions of the ratings agencies in issuing these ratings were not reasonable, and failed to provide for, at a minimum, the prospect of a national decline in housing prices, and for the national decline in underwriting standards. Another problem was the immense complexity of these products. Interviews I have conducted for a book on the
stages of a financial crisis, and the faults of the current views of the nature of market
rationality in neoclassical economics, shed some additional light on these issues.

On 22 September 2009 I interviewed Mr. Jerome Fons, a former Managing Director at the
ratings giant, Moody’s Investors Services, in his flat on the Upper East Side of Manhattan.

Mr. Fons was essentially forced out by Moody’s in 2007 during a “reorganization” in which
those in senior management who not were on board with Moody’s increasing focus on the
structured finance rating business were encouraged to depart. In his words:

“I was seen as being bad for the structured business. So I lost my job including about 20
others, including my boss. I was on the wrong team at that time and his team [the structured
finance business advocates] won and so he was going to get rid of the other team.”

When I promised Mr. Fons that this information would not appear in my written work he said

“I don’t care. I’m pretty safe.” He signed no non-disclosure agreement with Moody’s upon
his departure on less than good terms, so he is not legally bound to any confidentiality
agreement.

While I have argued that U.S. government policies helped to generate a huge market
for RMBS securities, with the assistance of the resulting GSE demand for these securities,
Mr. Fons shed’s plenty of light on our questions about the problematic assumptions
underlying the ratings issue for RMBS and other Collateralized Debt Obligations (CDOs). I
will quote him at length, in response to my question “Back to your Moody’s days, was it a
tsunami, or a mistake?” Fons replied:

“How much of the problem at the ratings agencies were due to poor modeling, and
analytics, vs. business driven greed and willingness to trade reputation for short term
profits? They [the ratings agencies (RAs)] helped create these markets. This was
their bread and butter. The structured finance sector generated the lion’s share of the
profits for these firms. The margins were ridiculously high in the structured area. This
was their golden goose and they were laying golden eggs. They didn’t know how to
say ‘no’.
You had opaque, highly complex securities and bankers with the ability to play rating agencies off of one another... They were unwilling to say ‘no’ and draw a line in the sand. They had shareholder pressure to perform... Why was not the possibility of house price depreciation factored into their models? They had fallen in the past, but they hadn’t recently. [Yale Economist Robert] Schiller had been warning for years they were going to fall. Even after house prices peaked and had begun to fall the RAs did not modify their models or methods and still continued to rate as if house prices were going to continue to rise. Why didn’t they incorporate declining under-writing standards? I don’t think they had an incentive to even look for those things. I think they had an incentive to keep the machine going, keep the party going, and to keep turning out these ratings, because they were trying to keep those stock prices up.”

Note that I have emphasized in the text above an assertion that the CRAs helped to create markets for structured finance ratings. Mr. Fons made a further claim in what follows.

I then I asked him how structured finance and the RAs should adapt in light of these problems. He answered, in part:

“Regulators are now saying ‘If you helped design the security, you can’t rate it.’ If you’re going to be a rater you need to be an impartial referee. They need to disclose their methodologies for rating and let the market say ‘here’s what we’ve got. Rate it or not’ If you want to be a consultant to Wall Street to help them create these things, that’s one thing, but the ratings firms shouldn’t be doing that.”

Mr. Fons clearly asserts that Moody’s personnel helped design the structured securities they then rated, and were under pressure in this process to help the firm being rated design a security some of whose tranches they could rate AAA, and were subject to pressure of competition from other raters. This begs another question, as regulators are “now” telling the RAs they can’t do this..” why did not these regulators, namely the Securities Exchange Commission (SEC) recognize and prohibit this practice before the crisis, particularly as they must have understood that the “issuer pays” structure of RA compensation surely subjected the RAs to moral hazard through competitive pressures alone? The conflict of interest, given the enormous profitability of the fees received for rating structured finance products that Mr. Fons avers, surely should have been obvious to regulators.
The three top ratings agencies, Moody’s, Standard and Poors, and Fitches; have since 1975 enjoyed the status of Nationally Recognized Statistical Rating Organizations (NRSROs). They have been a government recognized oligopoly, and numerous regulatory requirements promulgated throughout both Federal and state law in the United States requiring various pension and insurance funds to be loaded up with securities rated “investment grade” only by these raters has entrenched that oligopolistic status.

These ratings have been institutionalised, they have become social facts. While the RAs have sometimes gotten it wrong, as in the last two decades with their spectacularly misplaced ratings of Enron, Worldcom, the sovereign debt of many East Asian nations during the Asian Financial Crisis, and RBMS and CDO structured finance products, they have more often gotten it, at least roughly, right. An alternative to the oligopoly has been difficult to identify. As Timothy J. Sinclair has recently argued:

“The reputation of Moody’s and S&P has been constructed over time through a combination of serving a need by offering to solve the information problem between buyers and seller, and by providing that information in a reliable way, generating epistemic authority for them. Even if individuals are skeptical about the rating agencies, they cannot assume others have the same view. Because of this risk, sceptical individuals have incentives to act based on the assumption that others will use the rating agencies as benchmarks – as what Searle calls social facts – unless they know this definitely not to be the case.” (Sinclair 2010: 99)

The error of the RAs was in rating products too complex to be rated or valued without highly complex computer models. A former senior analyst for JP Morgan, London, who helped develop structured financial products in the late 1990s suggests that the complexity of structured CDOs comprised of huge pools of residential mortgages are an application of structured finance he had not envisioned when he helped create JP Morgan’s original BISTRO (Broad Index Secured Trust Offering) products. I provide a fragment of the transcript of my interview with him in New York on 12 March 2010, in which I will simply identify him as “I” for “interviewee” until I have been able to pre-approve he is comfortable
“on the record” with these remarks, I had to agree to grant him anonymity of his person and firm.

“RBH: Is there a difference between BISTROs and Collateralized Debt Obligations (CDOs) that ended up generating so much difficulty in the financial system? Would you describe this, please?

I: The BISTRO transactions were a way of creating portfolios of corporate credit exposure in a way that would aggregate, typically, 100 different companies’ exposures, into a single block like a mutual fund would aggregate 100 different stocks.

RBH: So corporate debt originally, not Residential Mortgage-Backed Securities (RMBS)

I: Correct. By doing that, it accessed various investor demands for diversified corporate credit exposure, and the names within the BISTROs were almost all investment-grade names, with published equity and credit research, and familiar. So the investors could look at the mix of exposures they were getting, and reach their own conclusions as to whether this was something they favored.

RBH: And then get high rewards for higher risk.

I: So the complexity of the structure was in contrast with the simplicity of the content. So if you look at the subsequent application of a similar tool, to RMBS, you compounded the complexity of the structure with the complexity of the underlying, where you have pools upon pools of individual ones, so there’s no way that the investor has confidence in the inputs to the structure. They were basing a lot of their judgement purely on the rating.

RBH: I’ve learned that a most people bought the rating wholesale. I had a risk analyst from Merrill Lynch telling me she didn’t do any fundamental default analysis on the securities, just liquidity analysis.

I: Because most of the people looking at the BISTRO had a view on each of the credits in the underlying BISTRO; it wasn’t that complicated, there weren’t that many names to have a familiarity with.”

The gentleman points out that the BISTRO structured financial products that he helped develop were designed to tranche out varying corporate credit risk exposure with higher rewards for higher risks. Small (typically 100) pools of corporate bonds were employed, and the names of the typically well-known firms were provided. S.E.C. 10-K quarterly reporting requirements ensured that the balance sheets and financial conditions of
all of the firms whose debt obligations populated the pools from which the BISTRO bonds (today synthetic bonds of corporate debt pools are known as CLOs) were synthesized could be scrutinized by those bidding for the various risk-weighted bond tranches. This fiduciary transparency was not available for the pools of thousands of home mortgages from what the RBMS CDOs were synthesized. Yet Federal regulators made no move to ban such complex, non-transparent products, instead relying upon the interest-conflicted RAs to accurately rate them.

I asked my interview subject to comment upon the theory that private governance in relation to these securities would allocate risk to those best placed and most able to bear the risk.

“RBH: The theory of synthesizing these securities, is tranche them out to super senior, senior, mezzanine, junior, and the folks taking the bigger risk are the ones who are looking for high reward and are willing to take that risk, like hedge funds. The hedgies would take on a lot of this stuff.

I: I don’t think that the theory is flawed, but many of the assumptions [behind synthesizing and rating mortgage backed securities] turned out to be massively flawed. If you think how these things are structured, one of the key assumptions is how much subordination to have at each level. So you think that by finding investors in the bottom 30%, that everything above that is super senior safe. That proved to be a hugely flawed assumption. If the level of subordination had been flipped on its head, and you had 70% of subordination, then that last 30% would have really been super senior. And there’s the people’s awareness of the imprecision of the estimation. From a social perspective, there were smart people who were naïve, and smart people who were bad actors; who preyed on naïve investors.”

There is plenty of blame to go around in my interview subject’s discourse. But clearly, regulators weren’t up to sorting the issues of appropriately assessing how much subordination was required in the synthesis of these securities. They abandoned that responsibility to the judgement of the ratings agencies. My interview subject has a view on the wisdom of this as well.

RBH: Do you have a view on whether the rating agencies should act differently than they do?
I: It’s astonishing to me that they haven’t been stripped of any official status, to start with. And this hiding behind the First Amendment [the RAs claim an absence of legal liability for errors on the grounds their rationings are just an “opinion” protected by the First Amendment of the U.S. Constitution] is just absurd. This whole institution that has been allowed to extract rents is clearly in need of removal.

However it’s unclear, however, that the financial markets will stop relying on their ratings. There are many impediments to an alternative to this oligopoly, though the SEC ruling will open up the ratings business to competition. And it is unclear, as Sinclair (2005) reminds us, that their reputational damage is adequate to abolish the “social facts” their ratings constitute, as suggested by bond market moves in response to their ratings downgrades for “EU peripheral” sovereign debt.

Unfortunately neither did the risk analysis shops of the big investment banks that underwrote and generated a lot of these securities do anything to check up on the judgment of the ratings agencies. In October 2009 I interviewed a now London-based risk analysts for Bank of America / Merrill who had the same job for Merrill Lynch in New York, prior to Merrill’s distressed buyout by BoA, while Merrill was still busy buying huge pools of newly issued junk mortgages and packaging them into RMBS CDO. I provide extended quotes from the interview transcript in this context below.

RBH: Were you involved in the risk assessment of those [RMBS CDO] securities that Merrill Lynch was creating?

SI: Yeah.

RBH: Could you describe that process for me?

SI: We looked at historical data on the underlying portfolio.

RBH: It was just two years for some of this stuff, no?

SI: Not really for the CDO, and especially not for the newly issued CDO. Let’s say if you put in RMBS, single A or above RBMS into a pool and then structure a CDO out of that pool. We want the historical data on the underlying pool. That CDO is too new at that time. The RMBS market has existed for a long time, so you can look back at the RBMS market history.
RBH: But you don’t have any history on the creditworthiness of the individual mortgages, so you assess what? The performance of the underwriting firm?

SI: No. See they are rated, right? They are rated by the rating agency. So you don’t really go to the individual mortgages.

RH: You didn’t do your own due diligence?

SI: It’s not part of what we do, in general. We bought the [mortgages that go into the] RMBS from them as a package. We bought the whole pool.

RBH: So did you assess the creditworthiness of the firms that underwrote the mortgages?

SI: No. The historical price of the RBMS [previously securitized mortgages] pool.

RBH: So how far does this that history go back?

SI: Three or four years.

RBH: [Chuckle]

SI: Um.. you don’t like three or four years..?

RBH: Well, what were the underlying assumptions in assessing the adequacy of three or four years historical data for your model? What did you assume that made you feel that was OK to only have 3 or 4 years of history and then project a default risk?

SI: It’s not really default risk that we are calculating?

RBH: Then what are you calculating?

SI: It’s called exposure. It’s the potential price, the potential marked-to-market movement in your underlying security. Because we don’t care about default risk, it’s not really what we do. We care about the price. Even if you have no mortgage default in your underlying mortgage pool, and there is panic in the market, it affects the price [of the security].

RBH: So it’s the risk that the market will devalue the security, that’s what you assess.

SI: Yes.

RBH: So that’s Keynes beauty contest, you’re making a bet, not that the value of the security is based upon default risk and fundamentals, you’re evaluating [risk] on the basis of what other market actors are going to pay for the security in the future.

SI: Yeah. It works very well for a liquid product. Let’s say I own 10% of a company’s equity, 10% of Microsoft, and one day I decide, “shit, I have a problem, I have to sell everything”. Ten percent, my God! I need to disclose with the SEC. If I see it everyone will know, I won’t get a good price, but I can look at Microsoft’s price
historically and see what is the worst scenario [into which] I could sell. Because of
liquidity and the position I hold it delays, and that delay is not something you can
quantify. There’s no model for something like that.

RBH: So if you have a large enough position you’re making the market, and
everyone’s paying attention to how much you’re selling. But what you’re telling me is
your analysis of risk on these securities is based on your expectation of its value in the
secondary market at a future date, not on the basis of your understanding of its
deviation from a fundamental value.

SI: Yeah.

RBH: [Laughter] That’s beautiful, [risk analyst’s first name]!

SI: [Laughter] You don’t like it..

RBH: I love it, because it’s grist for my mill. It’s not what neoclassical economics
would tell us what you would be doing as a risk analyst.

Merrill’s risk analysts clearly just bought the AAA rating wholesale, and the only risk
analysis they performed was on the historical pricing data of pools of mortgages of the sorts
they were acquiring to employ in creating structured bonds, and on the historical pricing data
of the bonds structured by them and others. No default risk analysis was performed, simply
liquidity risk analysis of the risks associated with holding a lot of the most senior tranches of
the bonds they were synthesizing on their own balance sheet. The super-senior tranches paid
out just a dozen basis points above US Treasuries, so the market for such low-yielding
tranches of these bonds was quite small, and since subordination of the tranches below them
was thought to limit the risk of holding, and the profits for sales of the subordinate tranches
so high, large investment banks like Merrill and Citigroup held a lot of the super-senior
tranches on their own balance sheet. As the default rates ultimately hit even these tranches
hard, this is what brought Merrill down for a distressed sale to Bank of America, and sent
Citigroup to the Fed for a bailout.

Our former Merrill risk analyst goes on to even more revelations.
SI: See, one of the problems is, people [packaging and buying RMBS CDO securities] really only go and look at rating. It was something in my job that made me very frustrated.

RBH: But you didn’t really evaluate default risk for [even the] super-senior [theoretically safest tranches]. You just bought the rating wholesale, and left it at that?

SI: But remember, S&P kept saying this was AAA, AAA, AAA.

RBH: So no more due diligence was done in house by Merrill?

SI: S&P would come and tell you, I’m S&P. They said, this is how we rated it, and we’d say, well people typically want AAA, so we’ll use your method to backward engineer our product to structure it. We’d backward engineer so S&P will give us a AAA.

RBH: An S&P officer in New York told me in late September [2009] that they didn’t cooperate with firms that structure these products.

SI: [Laughter]

RBH: You’re laughing!

SI: [Laughter] It’s interesting, I had a job interview with S&P, and they actually told me everything they publish and they share it with everyone.

RBH: What did they tell you? Did they tell you they cooperate with the investment bank?

SI: No, not per se, but they are very “transparent”, let’s put it that way.

RBH: Transparent enough that an investment bank can use their methodology to backward engineer a AAA rating for the super-senior tranche.

SI: Not only the super-senior

RBH: Also the senior, mezzanine, even junior tranches?

SI: Yes.

Two observations are warranted from this exchange for our purposes. First, a AAA rating of any product from the ratings agencies appears to have been a social fact of the first magnitude. It was unquestioned by highly skilled financial professionals as an absolute guarantee of an investment grade financial vehicle with essentially no default risk. Nothing better justifies Tim Sinclair’s (2005) constructivist analysis of the credit rating agencies than
the power this social fact exercised in helping to generate financial crisis on the balance sheets of those who synthesized and sold, and those who bought RMBS CDO. As my interview subject insists, if Standard and Poors said it was AAA, then it was bloody well AAA, default risk was assumed to be nil, and liquidity risk was her only concern. Who was she to question the rating? “I’m S&P. This is how we rated it... AAA, AAA, AAA!” In response to unanticipated levels of subprime defaults the rating agencies downgraded 92 percent of RMBS deals issued in 2006, and ultimately Moody’s downgraded 83 percent of the AAA backed CDO tranches and all of the Baa rated trances (FCIC 2011). In response to the revelation that AAA from the ratings agencies for structured financial products could instead mean “junk”, markets for these securities collapsed, and a number of additional markets were to follow.

Second, Jerome Fons’ charge that Moody’s raters of RMBS structured financial vehicles “helped create” these products is echoed by our former Merrill risk analyst against Standard and Poors, who laughed when I told her a Standard and Poors officer had told me his firm played no role in helping to structure these products. We cannot know whether raters actively cooperated with synthesizers of structured RMBS. I have found it impossible to obtain interviews with current employees of Moody’s or Standard and Poors with the exception of Mr. Jayan Dhru, Standard and Poor’s Managing Director of Global Banking. This is likely due to extensive ongoing litigation faced by the ratings agencies over the failed ratings on these securities. It’s worth noting that my interview with Mr. Dhru was witnessed by another, largely silent employee of Standard & Poors who took copious notes, and gratefully accepted my offer to provide a copy of the digital record of the interview to him on CD ROM by post.

RBH: Some have made the assertion that the rating agencies were implicitly engaged in assisting in the design of these products, and that in order to engage in some regulatory arbitrage and evade the capital adequacy requirements of Basle II stuff had
to be cranked out AAA in order to go off-balance-sheet into SIVs and so forth. So they would come and say to Moody’s, S&P, Fitch’s, “could you help us sort how to generate AAA securities in these structured products”? and that you did advise to some extent. Is that incorrect?

Dhru: Yes.

RBH: It is incorrect?

Dhru: Yes it is incorrect. We do not structure securities, at all. What we do is we make our criteria very clear, that this is how we rate it, and it’s available to anybody. It’s on our free website in fact.

RBH: Your methodology?

Dhru: Our methodology, yes.

Our former Merrill risk analyst’s interpretation of Standard and Poor’s transparency of their rating methodology of structured products is clearly at variance with Mr. Dhru’s interpretation. I am not qualified to make any judgements about the matter. While the raters admit faulty assumptions in their ratings models for these products, it’s entirely possible that any malfeasance in the use of the models by others is entirely the responsibility of those who employed them to “backward engineer” the structure securities to ensure AAA ratings. The rater’s methodologies contained faulty assumptions about the quality of the underwriting standards for the mortgage pools from which these products were generated. But it’s unclear that the raters should know more about the quality of the mortgage pools than the investment banks who purchased those pools for securitization.

For our purposes, at the least, it’s unclear why the potential for misuse by investment banks structuring RMBS of the publication of ratings methodologies should not have been considered and of concern to the RA’s regulators. Ratings methodologies are normally held closely as proprietary by the ratings agencies for most investment vehicles. Dereliction of duty by regulatory authorities in this matter had enormous consequences, as we shall see, when the Fed and U.S. Treasury let Lehman Brothers go down. Nobody knew how much
toxic RMBS any of their counterparties had on their balance sheets. Trading in this and many other asset classes essentially halted. Credit collapsed as most major U.S. financial concern hoarded cash, unable to tell what was on the balance sheet of their counterparties, and uncertain of their own solvency if they had significant exposure themselves.

**The Expectation that the US Government Would not Permit a Systemically Important Institution to Fail:**

Vincent Reinhart has recently argued that the decision by former U.S. Treasury Secretary Hank Paulson and Federal Reserve Chairman Ben Bernanke to let the investment bank Lehman Brothers fail in September 2008, subsequent to creating “false hopes” in resolving Bear Stearns in March of that year, was responsible for the collapse of liquidity and the “resulting market seizure” immediately following Lehman’s bankruptcy filing. (Reinhart 2010).

I have conducted over 40 interviews with financial professionals since the crisis at this writing. I recall no interview that did not specify the Treasury and Federal Reserve’s decision to permit Lehman Brothers to fail in September 2008 as the game-changer that brought trading in many asset classes to a halt, and generated a liquidity crisis of the first magnitude, as everyone started hoarding cash.

Typical of my interviews in this context is this exchange with a Vice President of a New York based hedge fund who at the time of the crisis was a Vice President with Merrill Lynch, responsible for creating and trading CMO – which are RMBS CDO “with an agency wrapper” – meaning a GSE guarantee against default. The gentleman required of me anonymity of his person and firm, beyond the description I have provided above, so I’ll designate his comments with the acronym FMCT for former Merrill CMO trader.

RBH: What do you think collapsed the liquidity?
FMCT: Biggest thing is uncertainty in the marketplace. Think about what [former U.S. Treasury Secretary] Paulson did. There was no predictability in what he was doing. No one knew what was going to happen next. If you have a marketplace with known rules, then the trust is there. But if you don’t know what especially the U.S. government is going to do, then you’re not going to participate in the market.

RBH: So you’re telling me there is a structure of expectations that public policy plays a large role in generating these intersubjective expectations between market actors?

FMCT: Yes.

RBH: So you care about central bank policy and Treasury policy being consistent

FMCT: Yes.

RBH: So letting Lehman go down bothered you?

FMCT: Yeah, I think it was one of their biggest mistakes.

RBH: What issues created this uncertainty that upset you?

FMCT: Lehman was the biggest. Merrill was in trouble. It [Paulson letting Lehman fail] told me they might let Merrill go down. But also when Lehman went down, when you think about the firms that you’re trading with, we didn’t know how much exposure they had to Lehman. So everyone was afraid to do business with each other.

RBH: So it was a lack of transparency in terms of counterparty risk.

FMCT: Yes. So look at LIBOR [London Interbank Offer Rates] rates then.

RBH: Economists would account for all this with words like “transparency”. Do you think that accounts for it? What signals of mistrust or lack of confidence did you observe in 2007/2008? When you don’t trust a counterparty, what is going on? Is it just a matter of information?

FMCT: The biggest thing is they won’t do trades with you. Even with Merrill, there were some counterparties that would not do trades with Merrill Lynch.

RBH: How do you know?

FMCT: Because it was in my product space. People I talked to said “we won’t do trades with you because of the risk involved.”

RBH: So you were with Merrill at that time?

FMCT: Yeah. If you just looked at our stock price it was trading the low single digits, a lot of shorts against us. There was a big fear that Merrill was going to go down. Same weekend as the [insurance giant] AIG bailout.”
My interview subject, along with many others I have interviewed, lays the market seizure directly at the feet of inconsistent and unpredictable Treasury and Fed policy toward bailouts. Coupled with this uncertainty, the decision to let Lehman fail generated complete uncertainty throughout the financial community regarding the exposure of their counterparties to the failed investment bank’s debt. Liquidity dried up as financial concerns hoarded cash to guard against their own insolvency, and denied credit to one another. Markets plunged and re-valued across asset classes, generalized collapse of confidence resulted, trillions of dollars of wealth was wiped off of balance sheets, both corporate and personal, and didn’t stabilise for 6 months after the Lehman bankruptcy, when the equities markets bottomed in March 2009.

The LIBOR spreads to which my interview subject referred are clearly, in his view a proxy for mistrust between banks. LIBOR is the rate banks charge one another for an overnight loan. They skyrocketed after Lehman’s failure, ultimately reaching over 400 basis points over the bank rate. No one pays for short term credit at 4 percent over the cost of the funds from the central bank. At those levels, essentially, bank credit was simply unavailable.

Reinhart points out that the particular form of the government’s resolution of failing Bear Stearns actually invited further speculative attacks on other firms, such as Merrill, and Lehman.

The official playbook appeared to protect creditors fully and to wipe out shareholders. This expectation makes it profitable to identify the next financial firm to be resolved and then to sell its stock short and use the proceeds to purchase its unsecured debt. If the candidate firm was identified correctly, the debt would appreciate in value and its stock collapse. The basic message is that repaying unsecured creditors at par creates an opportunity for capital
gain. The government creates an expectation that it will intervene in this way, market
participants bring forward the pressures officials fear in a classic speculative attack.
While this is no doubt the case, there is no reason to believe an outright failure of Bear
Stearns that failed to protect its creditors would not have simply moved the crisis forward 6
months from September to March 2008. Reinhart is anxious to blame the government for
intervening at all, and thereby generating moral hazard. I believe if he had interviewed as
many people as I did that suggested it was indeed Lehman’s failure that seized up markets,
he’d be unlikely to assert the expectation didn’t pre-exist the Bear Stearns resolution by a
forced sale to JP Morgan at $2 a share. The Fed had resolved the failing hedge fund, Long
Term Capital Management, in 1998, with a New York Fed brokered infusion of private
capital, over concerns that it’s high leverage would generate a systemic financial crisis if
allowed to fail. My interviews suggest that had the Treasury allowed Bear Stearns to fail,
this would have generated more surprise, and an earlier crisis, than the decision to resolve it.

**Conclusion:**
Students and admirers of Karl Polanyi will find much familiar with the analysis
above, as Polanyi famously reminded us that markets rely upon stable political foundations.
(Polanyi 1957) It’s perhaps a pity that neither former US Treasury Secretary Hank Paulson,
nor former Chairman of the US Federal Reserve, Benjamin Bernanke, appeared to be familiar
with Polanyi’s lessons in this context. What this constructivist analysis has hoped to
contribute is the demonstration that markets rely upon a system of stable intersubjectively
shared social understanding about economic cause and effect in addition to the political and
institutional environment in which they are operating to function properly. Our
understanding of the nature of market rationality has, perhaps, a long ways to go.
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