# Blind Oracle

## A Response to “Never Saw It Coming”

*Richard Katz*

In his recent essay “Never Saw It Coming” (November/December 2013), Alan Greenspan makes two central arguments: first, that virtually no one foresaw the 2008 U.S. financial crisis and, second, that irrational “animal spirits” were the root cause. If true, these propositions would absolve policymakers such as Greenspan of blame. But neither holds water.

The truth is that many experts worried about the U.S. housing bubble and predicted a crash, even if they couldn’t pin down its timing or severity. As early as 2002, Congress summoned Greenspan himself to discuss “the possible emergence of a bubble in home prices,” a concern he repeatedly dismissed. A year later, the economists Robert Shiller, who won last year’s Nobel Prize in Economics for his work on financial crises, and Karl Case voiced just that worry. Also in 2003, 50 of the top U.S. newspapers ran a combined 268 stories referencing a “housing bubble.” By 2005, they had run an additional 1,977 such stories.

What turned the eventual bursting of that bubble into the worst financial crisis since the 1930s was not animal spirits but unregulated derivatives—complicated financial instruments whose value is “derived from” an underlying asset. Some derivatives, such as corn futures, can help economic growth, but that did not happen here. In the case of home mortgages, financiers bundled millions of toxic loans using the mortgage income as supposed backing. Then, they created a second layer of derivatives supposedly based on the value of the first set, and so on. In the end, the total package—built on such strange-sounding concoctions as “synthetic collateralized debt obligations” and “naked credit default swaps”—had a face value of $35 trillion, 14 times the value of the mortgages supposedly backing them. This explains why the 2008 financial crisis was so much larger than the housing crash that triggered it.

Greenspan was one of the chief advocates of deregulating finance, including derivatives. Testifying before Congress in 2005, he asserted that even if home prices declined, they “likely would not have substantial macroeconomic implications. Nationwide banking and widespread securitization of mortgages make it less likely that financial intermediation would be impaired than was the case in prior episodes of regional house price corrections.”

But many others correctly predicted that this house of flimsy cards would actually amplify the effects of a decline in home prices. As early as 2002, the investor Warren Buffet argued that the more exotic derivatives were “financial weapons of mass destruction.” And in 2005, Raghuram Rajan, then the International Monetary Fund’s chief economist, warned of the dangers created by new “perverse incentives” for financial managers. Banks, he said, were “employing risky derivatives strategies to goose up returns.” In the event of a downturn

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in the assets behind these derivatives, such as housing, "the interbank market could freeze up, and one could well have a full blown financial crisis."

Former U.S. Treasury Secretary Larry Summers publicly dismissed Rajan as a "Luddite." Seven years earlier, Summers had quashed an effort by Brooksley Born, then chair of the U.S. Commodity Futures Trading Commission, to regulate some financial derivatives. "I have 13 bankers in my office," Summers told her in a phone call at the time, "and they say if you go forward with this, you will cause the worst financial crisis since World War II."

## RATIONAL FACTORS

By blaming the financial crisis on "animal sprits" and "irrational factors," Greenspan suggests that no one is at fault. The real problem, however, was that although most players had pursued their own interests rationally, they had, as Rajan put it, "perverse incentives."

Greenspan and other proponents of radical deregulation claimed to be liberating market forces. But markets cannot work properly unless healthy institutions nurture them. That includes making sure that each key player has independent interests so that each can balance the power of the others. In this environment, what is good for each player is generally good for the economy as a whole. By removing many existing checks and balances, radical deregulation ended up undermining the market.

Perhaps the most perverse incentives were those governing the behavior of CEOs of financial firms, for there was little to dissuade them from enriching themselves at the expense of their firms and shareholders. CEOs routinely took on the additional role of chair and filled their boards with fellow CEOs seeking equally generous compensation deals. If they took big risks that worked out, these executives were given enormous rewards; yet even when the gambles failed, they still won big. Stanley O'Neal, the former chair and CEO of Merrill Lynch, walked away with $165 million after ruining the company. And according to one Harvard study, Lehman Brothers' last chair and CEO, Richard Fuld, ended up with a net $222 million from the bankrupt firm.

Mortgage lenders, too, had skewed incentives, since they no longer kept the loans on their own books, instead passing them on to investment banks, which bundled and sold them as derivatives to investors. These lenders now had little stake in whether borrowers could pay back the loans. As a consequence, lenders approved huge numbers of mortgages that did not require the borrowers to document their ability to pay. Many financiers themselves reportedly dubbed these mortgages "liar loans"—which suggests that they, too, may have been committing securities fraud. Yet Greenspan refused to use the powers that Congress had given him in 1994 to require nonbank mortgage issuers to follow the same simple rules applied to banks: you can't lend to people without a down payment, without proof of ability to pay, and without a beating heart (there were several reported cases in which lenders approved mortgages for deceased individuals).

The credit-rating agencies, whose impartial judgments investors relied on, faced their own perverse incentives. After decades of being paid by investors, in the 1970s, they switched to earning fees from lenders. This gave the agencies a financial interest in assigning high ratings to trillions of dollars' worth of toxic assets.

At the same time, regulators weakened legal deterrence. After the collapse of Lehman Brothers in 2008, Timothy Geithner, then president of the Federal Reserve Bank of New York, told Andrew Cuomo, then New York's attorney general, that Cuomo's investigations into Wall Street malfeasance could destabilize the financial system. The result was a de facto policy of protecting financiers deemed "too big to jail." It is hard to think of any major player who has even been indicted, let alone convicted and jailed. What a contrast to the prison sentences for a host of corporate fraudsters, such as the executives at Enron and WorldCom, in the early years of this century. Geithner had reason to know better. As the U.S. Treasury's attaché in Tokyo during the early 1990s and then as a senior Treasury official, Geithner had participated in the Clinton administration's criticism that excessive leniency on the part of Japan's Ministry of Finance had prolonged that nation's banking crisis. Even today, the U.S. House of Representatives is allowing lobbyists for Citigroup to draft the words of laws aimed at weakening parts of the Dodd-Frank financial reform law relating to derivatives. Congress members deemed friendly get more campaign contributions from Wall Street.

As a result of all these changes, what was good for each powerful player was no longer good for the system as a whole. Greenspan failed to recognize this danger, not for lack of evidence but because he wore ideological blinders. Born later recalled Greenspan telling her, "You probably will always believe there should be laws against fraud, and I don't think there is any need for a law against fraud." He simply believed the market would correct itself. It was not until 2008 that Greenspan admitted in congressional testimony that he had "made a mistake in presuming that the self-interests of organizations, specifically banks and others, were such that they were best capable of protecting their own shareholders and their equity in the firms."

Regulators need not be soothsayers or micromanagers, but they must safeguard the market from conflicts of interest, perverse incentives, and collusion. With the proper checks in place, market players will have an interest in doing the right thing. Lenders who have to keep on their books even parts of the loans they make are more likely to make sure that the borrowers can repay those loans. CEOs compelled to return compensation if their firms suffer major losses would be more hesitant to make reckless bets with other people's money.

To be sure, booms and busts will come and go. But their severity can vary dramatically based on the policies in place to prevent them. With stronger regulations, neither the housing and derivatives bubbles nor the eventual crash would have been so bad. Shifting the blame from identifiable perverse incentives to vague talk of "animal spirits" leaves us more vulnerable to a repeat.