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American Consumers, Easy Credit and the Economic Crisis

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|| Abstract

The American character is defined by a bigger, higher, faster mindset. Throughout its history, this has been the United States' great strength. In the 20th century, the bigger-higher-faster mentality produced a parade of American successes, attracting talented immigrants from across the globe and spurring a century of unparalleled invention and ingenuity. Two generations ago, bigger-higher-faster stood for innovation: the jet airplane, the towering and beautiful skyscraper, or the efficiency of the assembly-line automobile. In today's America, defined by its consumeristic excess, bigger-higher-faster means bigger houses, higher debt, and faster gratification. The bigger-higher-faster mentality that has always defined America has cross-pollinated with another strain of Americana—consumerism—to calamitous results.

The global financial crisis stands as example one of the disastrous results of Americans' consumeristic excess. While popular lore holds that the financial crisis is the product of greedy Wall Street bankers, avaricious speculators, and mendacious mortgage brokers, the primary perpetrator is the average American who lusted after a house far beyond his means, furnished it with fixings he could not afford, and paid for everything using easily available credit. For nearly a decade, banks gave platinum credit cards and half-million-dollar mortgages to nearly anyone who asked for them, racking up fat profits. Beginning a generation ago, Wall Street investment bankers created new tools for financing debt—and American consumers began racking up debt in then-unthinkable amounts. In a generation, personal savings dropped from 10 percent of income to -2.5 percent—less than zero. In the past 25 years, American consumers have accumulated more than $15 trillion worth of debt. The financial crisis owes its existence to this debt—or rather, the realization that much of it stands never to be repaid. In the history that has already been written since the meltdown of the financial markets in September 2008, it is the much-maligned Wall Street fat cats who shoulder the whole of the blame for the meltdown of the financial markets and the worst recession in recent times. But this interpretation omits the key detail of how Americans' debt grew so large and so fantastic. Bankers have a fiduciary responsibility to maximize profit and increase their share prices. Individuals have a responsibility to live within their means and look after their own financial well being. Moral judgments aside, it is clear who failed to meet his responsibility.

INTRODUCTION

For more than half a century, three stereotypes have defined the typical American: He drives a big car, lives in a big house, and fills the big house with lavish accoutrements. Like many national stereotypes, this one is entirely true. What is left unsaid—but is now blindingly apparent—is that the stereotypical American cannot afford the big car, the big house, or its requisite flat-screen televisions, espresso machines, and ionic air purifiers. Today, after the calamitous collapse of credit markets and the ensuing worldwide economic crisis, new stereotypes alleging financial hedonism and cosmically bad judgment are more likely to be heard than the old standbys. But these new stereotypes are not new at all; they merely reflect the realities that fueled the engine of America's legendary consumer excess for more than a quarter century. Financial hedonism explicitly drove and enabled consumer hedonism.

Fueled by the rise of easy credit, Americans embarked on a 25-year buying bonanza which saw them drive ever-bigger cars, build ever-bigger homes, and buy even more things. The bonanza would not end until 2007 and 2008, when credit markets froze, oil prices peaked at an all-time high, and the world faced its biggest financial and economic crisis since the Great Depression. Even without a thorough post-mortem, the root causes of the crisis are clear: a reckless mortgage market and imprudent consumer lending—that is to say, big houses, big cars, and lots of lavish accoutrements.

The financial and economic crisis is popularly presented as the result of adventurous bankers and greedy Wall Street types taking foolhardy gambles. But this only tells half of the story—and not the

important half. Like any market of ill repute, a seller needs a buyer. Just as a drug dealer needs a junkie, the much-maligned Wall Street type needed a customer to finance his fast-growing portfolio of financial products. The Wall Street suits found plenty of eager borrowers: mortgage customers to the tune of $14.6 trillion[1] (including $1.3 trillion of the now-infamous sub-prime mortgages[2]), and credit card customers who racked up $975 billion in bills to haul home with plastic what they couldn't afford with cash (banks' conservative projections foresee customers defaulting on at least $82 billion worth of that debt in 2009 and 2010 alone—nearly 10 percent of all outstanding credit card loans).[3] The average American has 5.3 credit cards in his wallet and credit card debt tops $8,000 per household on average.[4] The amount of money lent to consumers was mind-boggling, but even more mind-boggling was the fantastic nature of the lending. Twenty-something families with combined incomes of barely $30,000 per year routinely received no-money-down mortgages for more than $500,000, putting a McMansion in nearly everyone's reach. University students with no income were pelted with offers for credit cards with credit lines of $20,000 or more. The money was cheap and easy, and until the bubble burst and sent the economy crashing down, everyone won. Consumers won by getting everything they wanted—the house, the television, a trip to Disney

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[1] The total value of all outstanding U.S. mortgage debt was $14.6 trillion in the fourth quarter of 2004, according to the most recent statistics released by the Federal Reserve Bank in March 2009. Statistics accessible online at http://www.federalreserve.gov/econresdata/releases/mortoutstand/mortoutstand20090331.htm

[2] Estimates vary on the total value of the U.S. sub-prime mortgage market. Most expert estimations fall between $1.3 and $1.5 billion. The $1.5 billion figure cited comes from Sumit Agaral and Calvin T. Ho of the Chicago Federal Reserve Bank. Their analysis of the sub-prime mortgage market is accessible online at http://findarticles.com/p/articles/mi_qa3631/is_200708/ai_n19433910/

[3] Consumer credit card debt peaked in the third quarter of 2003 at $976.8 billion. The most recent Federal Reserve Bank projections released on May 7, 2009 estimate that consumer credit card debt declined slightly to $949.5 billion in March 2009. Statistics accessible online at http://www.federalreserve.gov/releases/g19/Current/

The $82 billion worth of expected credit card loan defaults was reported in the New York Times on May 11, 2009 and represents 8.6 percent of all outstanding credit card debt, as reported by the Fed. The same article quotes other economists who envision defaults totaling as much as $141.5 billion. Article accessible online at http://www.nytimes.com/2009/05/11/business/11credit.html?hp

[4] Data as reported by The Nilson Report and quoted in the New York Times Magazine story "What Does Your Credit-Card Company Know About You?" May 17, 2009. Accessible online at http://www.nytimes.com/2009/05/17/magazine/17credit-t.html?pagewanted=2&hp

World—all paid for by cheap and universally available credit. But the bankers won even bigger: everyone from the call center operator up to the corner-office CEO had his had his salary hinge on how many loans he sold, creating a perverse incentive to sell as many big loans as possible. Whether those loans performed was something to be dealt with at a later time—now.

REVISIONIST HISTORY UNFOLDS

As the financial system—and the economy with it—came crashing down in the fall of 2008, public reaction was as vitriolic as it was absurd: populist cant, albeit somewhat ungrammatically, cast the American people as either Main Streeters or Wall Streeters—as hard-working embodiments of the Puritan work ethic or as avaricious, manipulative money-dealers with absolutely no scruples to be found. To be sure, there is plenty of blame to go around. The so-called Wall Streeters built a house of cards out of largely unregulated financial products. Politicians, even those who delight in stoking populist rage, set policy that explicitly encouraged the detested Wall Streeters to make imprudent loans. But for the sainted Main Streeters to wave their pitchforks at Wall Street or Washington is myopia *ad absurdum.* It was the Main Streeter who went from saving more than 10 percent of his paycheck in 1980 to spending 2.7 percent more than he earned in 2005.[5] It was the Main Streeter who spent so far beyond his means that the average credit card debt now tops $8,000 per household.[6] And, of course, it was the Main Streeter who couldn't settle for a modest home actually on Main Street, and instead opted for the garish McMansion in some far-removed subdivision—all financed with a cheap, few-questions-asked adjustable-rate mortgage.

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[5] Personal Saving Rate as reported by the U.S. Department of Commerce's Bureau of Economic Analysis on April 30, 2009. Data accessible online at http://research.stlouisfed.org/fred2/data/PSAVERT.txt

[6] As reported in "The Debt Trap" series in the New York Times in July 2008. Article accessible online at http://www.nytimes.com/2008/07/20/business/20debt.html?pagewanted=3

So while the popular narrative of the financial crisis tells a head-scratchingly wonky tale starring collateralized debt obligations, mortgage-backed securities and credit default swaps—one so complicated that one can't help but throw his hands up in the air and lash out at the conniving Wall Streeter—the real story is much simpler, and unfolded much closer to home: Americans bought and borrowed massively more than they could afford. The demonized and inscrutable financial products were in most cases nothing more than a means to an end: enabling the American consumer to consume beyond his means. "We are waist deep in evasions because one cannot talk sense about the cultural roots of the financial crisis without transgressing this cardinal principle," wrote the political commentator George F. Will last October, just as the enormousness of the economic crisis was setting in. "Never shall be heard a discouraging word about the public."[7]

Sure enough, the public, politicians, and popular lore have heeded this maxim, and the story of the sharpest economic crisis in half a century omits the role of its key protagonist: the American consumer. This account of the 25-year binge of borrowing and consumerism will recount the symbiotic rise of debt-based Wall Street securities and debt-driven Main Street consumerism. It will trace the origins of the economic crisis back to the beginning of the 1980s, when a gold card became the key to upper-middle-class yuppiedom, through the halcyon days of debt-financed lifestyles in the mid-2000s, and finally to where we are today: In a post-bubble financial catastrophe, where it is plainly obvious that the entire system—both the financial system and the values system that exalts and celebrates consumption—is untenable.

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[7] "A Vote Against Rashness" by George Will. October 1, 2008. Syndicated by the Washington Post Writers Group. Accessible online at http://www.realclearpolitics.com/articles/2008/10/publics_fury_noted_now_is_time.html

This examination will span more than a quarter century and will cover many themes, all of which are necessary to understand how we arrived at the calamitous economic situation we find ourselves in today. This study is divided into six chapters, each covering a specific theme that contributed to the crisis. This examination starts with a basic explanation of the immediate triggers of the financial crisis; it attempts to answer the question *why did the financial system melt down when it did, and how?* Then, the study moves on to the underlying causes of the financial crisis that mounted over a 25-year period. It examines the rise of mortgage and consumer debt, and then takes a look at its twin brother: the Wall Street financial tools that encouraged banks to make credit ubiquitous and universal—and that drove Wall Street profits through the roof in boom times. Next, the study will cover the sociological elements that drive American consumerism and inflated the credit bubble until it could hold no more three-car garages, Blu-Ray players and Ron Popeil Pocket Fishermen. Attention then turns to the decade of the financial developments of the 1980s and 1990s. First, the study will explore the massive success of the mortgage-backed security, how it gave rise to Wall Street, and shifted the center of power in the nation's banking system away from small banks and toward large investment banks. Then the study will examine the backlash in the 1990s: the consolidation and corporatizing of commercial banks, which gave rise to the mortgage industry that plagues the financial system of today. The examination will then explore the role government, lawmakers, and policy makers played in laying the groundwork for the credit and housing booms and their corresponding busts. Finally, the study concludes with two chapters analyzing the current state of affairs. The penultimate chapter examines explicit causes and effects between the 25-year orgy of credit-fueled consumerism and the 2007-2008 calamities in the financial system. The final chapter explores the fallout of the financial crisis and the prospects for more sane and responsible consumer spending habits in the wake of catastrophe.

1|| Countdown to Meltdown

The financial meltdown of the autumn of 2008 was a generation in the building and built by a generation defined by excess and shortsightedness. The purpose of this project is to explore the extravagance and irresponsibility that, unchecked for more than 25 years, led to an inevitable financial collapse. But before we examine the myriad sociological, political, business, and personal lifestyle phenomena underlying the decades-in-the-making financial crisis, a clinical blow-by-blow of the events leading up to the 2008 crisis would serve us well in understanding why the financial system cratered when it did, and in comprehending the key factors that led events to unfold in the manner that they did.

If the calamitous financial meltdown of 2008 were to be explained in one word, then choosing that one word is simple: *mortgages*. For a generation, home ownership was the key for success in political, investment, and personal finance, and macroeconomic realms. In 2000, this phenomenon was thrust into overdrive with the election of George W. Bush, who made expanding homeownership a political priority. Everyone from politicians to investment bankers, all the way down to the average consumer, bought into the notion that home ownership was his ticket to individual success—and thus, the real estate boom (or bubble) between 2000 and 2006 marked a then-unquestioned success for everyone involved. It was, however, a success that hinged on the impossible: home values always increasing. The Bush administration and members of Congress on

both sides of the aisle trumpeted what they called the "ownership society," a grand-sounding term that, in the context of homeownership, meant nothing more than having as many people as possible own their homes. Politically, this was an extremely uncontroversial proposition. Home ownership had always been held to be a universal good, and government policy now ridiculed as reckless and toxic was hailed in nearly all quarters as enlightened and virtuous. The federal government had many tools at its disposal to spur on its ownership society (a phrase that, not incidentally, became a standby in President Bush's 2004 re-election campaign stump speeches[8]), all of which can be said to effect a broad policy goal: to create ways to loan money to people who were previously considered credit risks (that is, unlikely to have the means to repay the loans) in order to allow them to buy a home—and buy into the ownership society.

THE FEDERAL GOVERNMENT

Fannie Mae and Freddie Mac, two so-called government-sponsored enterprises (GSEs)—private companies with access to low-interest capital usually available only to government borrowers who also enjoyed the implicit backing of the federal government—were and are the most important entities in the secondary mortgage market, the somewhat byzantine but nevertheless crucial part of the mortgage system. On the secondary mortgage market, companies like Fannie and Freddie buy mortgages made by banks to homeowners and then resell them, usually as securities. Secondary mortgage buyers play the critical role of keeping the mortgage market "juiced" by buying mortgages from banks and then assuming the risk of possible default. The arrangement provides the

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[8] See, for example, many examples listed by Naomi Klein in her article critical of Bush's "ownership society" policies in her January 2008 article for The Nation, "Disowned by the Ownership Society," accessible online at http://www.thenation.com/doc/20080218/klein. A cursory search of Bush's 2004 campaign speech transcripts will turn up the phrase dozens of time.

banks with capital which they can then use to write more mortgages. In essence, secondary mortgage purchases mean that banks' ownership of mortgages that they issue seldom last the 20- or 30-year term that they are written for. GSEs pay a premium on the mortgage, giving the bank a nice profit and shifting any risk—along with the mortgage iteself—off of the bank's ledger and onto the secondary buyer's.

GSEs, led by Fannie and Freddie, collectively hold or pool more than $4.8 trillion worth of mortgages—nearly half of the American mortgage market.[9] Understanding the immensity of the power of Fannie, Freddie and the other smaller GSEs in keeping the mortgage market running is critical in understanding how their decisions affect home ownership, bank lending, and the economy as a whole. Since the early days of the Bush administration, expanding the "ownership society" had been a key presidential priority. Enjoying the president's publicity offensive and a bi-partisan Congressional effort to expand homeownership to those who found themselves unable to buy homes or qualify for mortgages under previous regimes, Fannie and Freddie were given legislative incentives to purchase sub-prime and alt-A mortgages—the two riskiest types of mortgages, which can now be said to have been given respectively to those who in any sane system would not have qualified any mortgage at all and to those who were borrowing well beyond their means (a more detailed explanation of these types of mortgages is given in Chapter 2). The GSEs, which purchased nearly half of all mortgages on the secondary market, were given incentives to purchase the two most risk-laden types of mortgages, and arrangement that made it obvious what banks dealing directly with homebuyers would do: give their customer what it wants. The

[9] Data on outstanding mortgage debt for the first quarter of 2009 from the Federal Reserve Bank is accessible online at http://www.federalreserve.gov/econresdata/releases/mortoutstand/mortoutstand20090331.htm. See item 55 for the total value of mortgages held or pooled by GSEs or items 56 through 76 for breakdowns by specific GSE.

customers in this case were Fannie and Freddie, which had a near monopoly on key segments of the secondary mortgage market. What they said they wanted were sub-prime and alt-A mortgages. The customers had voracious appetites.

THE BANKS

By spurring the GSEs to buy risky mortgages, the federal government created a perverse incentive for banks to make wildly risky loans. With the GSEs given the mission to buy risky loans from banks, banks were essentially instructed to make risky loans: why would the bank care if a loan were unsound if it would be able to sell it to a GSE at a profit and take it off of its balance books? The answer, of course, is that it wouldn't. But to pin the blame for the GSEs' misguided adventure in radically expanding the market for imprudent loans on the government ignores the important fact that Fannie and Freddie actively sought to expand the mortgage market with risky loans. Fannie and Freddie, despite their close relationship with the federal government, were for-profit corporations who sought to grow their businesses by acquiring more mortgages. Fannie and Freddie would then make their money by packaging the individual mortgages that they bought from banks into securities made up of hundreds or thousands of mortgages, and then selling them to Wall Street. The more mortgages Fannie and Freddie could get their hands on, the more they could sell to Wall Street. With what seemed like a clear-cut business model—more mortgages, more profit— Fannie and Freddie spent a combined $170 million on federal lobbying efforts from 1997 to 2007, which centered almost exclusively on preventing government regulation on their businesses.[10] When Bush-era policies encouraging risky loans like sub-prime and alt-A mortgages came along, Fannie

[10] As reported by the Associated Press on July 17, 2008 in the article "Fannie Mae, Freddie Mac spent millions on lobbying." Accessible online at http://www.usatoday.com/money/companies/2008-07-17-fannie-freddie-lobbying_N.htm

and Freddie didn't see it as a danger—they saw it as a growth opportunity. In 2004, Fannie and Freddie bought 44 percent of all sub-prime mortgages sold on the secondary market that year, 35 percent in 2005, and 25 percent in 2006.[11]

THE CONSUMER

As guilty as the federal government and the GSEs may have been in laying the groundwork for the sub-prime crisis, none of it would have been possible without the American consumer. As housing prices rose above historic norms starting in the mid- and late 1990s, individuals began shifting assets from stocks and into housing, igniting demand for housing, further driving up the value of real estate. With real estate values on a meteoric rise, banks began to consider loans to risky customers not as risky in and of themselves—after all, the customer may not have been ideal, but his property would be worth 20 percent more in a few years' time. If he couldn't pay his mortgage, he could borrow against the increased value of his home or the bank could foreclose—at a profit. In fact, the foreclosure epidemic of 2007-2008 wasn't the first large wave of foreclosures in the 2000s; during the 2001 recession, many borrowers had their houses foreclosed upon, but because their values had increased substantially, the banks often made a profit.[12]

The homebuyer didn't enter into the transaction as a dupable dolt. Despite the smorgasbord of dubious mortgages he had to choose from—the adjustable rate mortgage with low initial interest

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[11] As reported in one of the early reports foreshadowing the crash in the sub-prime market on the MarketWatch Web site. The article ("Fannie Mae could be hit hard by housing bust: Berg) from September 2006 reports that possible losses at Fannie could amount to $29 billion, a number several orders smaller than its actual losses. Article accessible online at http://www.marketwatch.com/story/fannie-mae-could-lose-29-bln-in-housing-bust-hedge-firm

[12] This phenomenon, along with many other phenomena that contributed to the financial crisis, was explained in a the *New York Times'* Freakonomics blog post by Price Fishback on May 12, 2009. Blog post accessible online at http:// freakonomics.blogs.nytimes.com/2009/05/12/the-financial-meltdown-now-and-then/#more-11107

rates that reset after a few years, interest-only loans, which required no payment of principal for years, the alt-A mortgages that charged a slightly higher rate in return for not requiring any income information, the sub-prime mortgages extended to those whose credit scores could disqualify them from many jobs—homeowners often had a plan to get around the cold fact that they didn't have the money to repay the mortgage. The plan was to live in the house for a few years and then "flip" it for profit—that is, to sell it at a higher price and pocket the difference. If they didn't flip it, they would borrow against the increased value of the house to secure a new mortgage. All of the plans counted on one then seemingly gospel truth: home values would only go up. And in the early 2000s, not only did it seem a safe bet to make, it was the accepted wisdom of no less than the United States government, the banks making the loans, the GSEs who bought them on the secondary market, and the Wall Street investment banks who bought the mortgage-backed securities.

WALL STREET

As if the trillions of dollars' worth of risky loans to unqualified borrowers weren't enough to sow the seeds of the mortgage collapse, the financial industry added another layer of complexity and uncertainty to the landscape. Beginning in the 1980s, Wall Street investment banks began buying and packaging mortgages from banks (and later from GSEs) and selling them as mortgage-backed securities (MBSs) that would then be sold like a bond. The MBS and related financial products, although today much maligned, actually played a constructive role in the mortgage market for decades, functioning like a private-market version of the GSEs: they provided liquidity to the housing market by giving banks more opportunities to sell their existing mortgages. In turn, the proceeds from the sale of the mortgages would be used to capitalize future mortgages for others.

Each mortgage-backed security represented thousands of mortgages, generally grouped together with other mortgages from the same lender of the same type and same amount of risk. Mortgage-backed securities worked much like bonds in that each MBS represented a stream of payments (homeowners making their monthly mortgage payment) and that they were priced and classified according to risk. For investors, mortgage-backed securities were essentially a flexible and much more liquid way to invest in the booming real estate market: rather than purchasing property, one could purchase a mortgage-backed security that represented monthly payments on thousands of properties.

But the byzantine financial products based on mortgages didn't stop with mortgage-backed securities. The collateralized debt obligation (CDO), a product that took off in popularity along with the housing boom, is a package of mortgage-backed securities composed of different tranches of MBSs. (A tranche is a piece or slice of a whole financial product.) CDO tranches were classified according to gradation of risk—meaning borrowing quality. A riskier borrower meant a higher likelihood to default. A CDO could be composed of 25 percent of a Class A-tranche MBSs (which represent revenue streams from qualified, vetted borrowers) and also composed of 25 percent of Class E-tranche MBSs (revenue streams from sub-prime mortgages). The advantage a CDO held over an MBS to an investor is that it allowed him to diversify his risk across many different types of mortgage revenue streams that promised either more lucrative returns (and more risk) or smaller, more reliable streams of revenue.

To reduce the risk of sharp losses in the values of CDOs and therefore make them more attractive investments, Wall Street created what is called the credit-default swap (CDS). The credit-default swap functioned like an insurance policy: should a CDO fall below a predetermined value, the firm underwriting the CDS would buy the CDO at a set price. As with an insurance policy, CDO-holders make regular payments to firms issuing CDSs. The American Intercontinental Group, better known by its infamous initials, AIG, was a leading issuer of CDSs, selling more than $500 billion worth of CDSs by 2007.[13]

Mortgage-backed securities, collateralized debt obligations, credit-default swaps and other labyrinthine mortgage-related financial products were not the cause of the financial crisis. The products themselves were sound. But when bad mortgages—those spurred on by the government and sought out by consumers eager to get in on the real estate boom—were sold and resold as financial products, the bad mortgages were spread out throughout the entire economy and spread like an epidemic. Banks, pension funds, individual investors, endowment funds all held MBSs and CDOs that were composed of mortgages just waiting to tank. And when the housing market began to tank in 2007, it would not be long before the entire economy would feel its weight.

THE HOUSING BOOM, THE MELTDOWN

By 2007, the inevitable came to pass: housing prices peaked and began a steady descent, eventually tumbling by more than than 18 percent in 2008 alone.[14] Even a small decline in housing values

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[13] As reported in a New York Times article on September 27, 2008 titled "Behind Insurer's Crisis, Blind Eye to a Web of Risk." Accessible online at http://www.nytimes.com/2008/09/28/business/28melt.html?_r=1&pagewanted=all

[14] As reported by MarketWatch on December 30, 2008 in an article titled "Home prices off record 18% in past year, Case-Shiller says. Accessible online at http://www.marketwatch.com/story/home-prices-off-record-18-in-past-year-case-shiller-says

would have presented enormous trouble for homebuyers who borrowed over their heads (as they needed their houses to increase in value in order to be able to afford the property in the long-term), but such a sharp downturn in housing prices truly spelled catastrophe for large tracts of mortgage borrowers. Large numbers of homeowners (and double-digit percentages of those with the riskiest loans) now saw the value of their homes go "underwater" when their homes' mortgages were more expensive than the value of their houses—sometimes by hundreds of thousands of dollars. Adding to the crisis was the fact that adjustable-rate mortgages issued at the height of the real estate boom in 2002 and 2003 were resetting at pre-stipulated four- and five-year intervals, with interest rates often doubling. If the homeowners' strategy had gone according to plan, then when the interest rates reset, they would either "flip" their houses or refinance their mortgages, borrowing against the increased value of the houses. But both of these options counted on the house increasing in value. As it played out, the houses were worth less, and just as mortgage payments skyrocketed, making them unaffordable even in good times, there was no escape hatch to pull: even selling the house and taking the cash would leave homeowners in the red to the tune of tens or hundreds of thousands of dollars.

Thus, the writing was on the wall. Throughout 2008, banks began foreclosing en masse on homeowners who could not make payments on their mortgages. Borrowers lost their houses, but that was just the beginning of the economic wreckage: the mortgages were now likely parts of mortgage-backed securities and collateral debt obligations; they weren't owned by the banks that wrote them, but were spread throughout the entire financial system. When borrowers defaulted, the GSEs, Wall Street investment banks, and individual investors who owned MBSs and CDOs all saw

their investments evaporate: large chunks of the properties that comprised their MBSs and CDOs were were less more than their corresponding mortgages.

By the end September 2008, the housing market bust and mortgage default crisis drove the financial system to the brink: AIG, the leading issuer of credit-default swaps (the insurance policies for CDOs), was unable to post enough collateral to back all of its CDSs and, on the brink of collapse, was taken over by the federal government. The government took an 80 percent stake in the company and extended $123 billion in credit to the slain giant.[15] Fannie Mae and Freddie Mac owned so many bad mortgages that they were taken under government conservatorship and given guarantees of $200 billion from the federal government, making explicit the longstanding implicit government backing of the two corporations. Meanwhile, Lehman Brothers, then one of the major investment banks in the United States, was driven to bankruptcy based on enormous losses stemming from its holding of CDOs made up of tranches of worthless subprime mortgages. Merrill Lynch, another major investment bank with significant subprime holdings, was forced by Treasury Department officials into the arms by the better-capitalized retail bank Bank of America. Bank of America is now ailing under the weight of Merrill's toxic assets. The two remaining U.S. investment banks, Goldman Sachs and Morgan Stanley, converted themselves into bank holding companies, leaving them subject to stricter regulation, but with easier access to capital—a must if they were to have the liquidity necessary to deal with the toxic mortgages on every investment bank's balance sheets.

[15] As reported in the Wall Street Journal on September 16, 2008. Article accessible online at http://online.wsj.com/article/SB122156561931242905.html

With Wall Street reeling from trillions of dollars of bad loans and banks clamoring for capital, the credit markets all but stopped flowing. The stock market reacted swiftly, with the Dow Jones Industrial Average falling from a high of 14,066 in September 2007 to 8,451 in October 2007, losing more than 3,330 points from August to October alone—more than 28 percent of its entire value in just six weeks—ushering in a massive recession. By May 2009, unemployment reached 8.9 percent, and topped 10 percent in many states.[16] The Dow Jones continued a further dive, reaching 6,547 in March 2009, before rebounding to October 2008 levels in May. The anemic economy thrust already vulnerable corporations into bankruptcy and tumult. With undercapitalized banks and nervous investors, many high-profile bankruptcies declared since October have already moved to the liquidation phase—something unthinkable just years ago. But no companies better illustrate the economy-wide damage the financial crisis has inflicted on the U.S. economy than the American auto companies. Already reeling due to years of myopic product choices and crippling labor and health care obligations, the carmakers saw their business drop off when the full effect of the financial crisis spilled over to the economy as a whole in September. Since then, Chrysler has filed for bankruptcy, announced plans to close numerous plants and lay off workers, and been forced into a shotgun marriage with Italian carmaker Fiat. General Motors, a much larger company, is an even bigger basket case: its stock essentially worth nothing and it too unwieldy to declare bankruptcy in any normal fashion, it now plans to sell itself to the federal government and its union workers in exchange for loans and assumption of debt.[17]

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[16] As reported by the Bureau of Labor Statistics on May 5, 2009. Data available online at http://www.bls.gov/cps/ (national) and http://www.bls.gov/lau/ (state)

[17] As General Motors outlined in its restructuring plan on April 27, 2009. As reported by Reuters on April 27. Article accessible at http://news.moneycentral.msn.com/ticker/article.aspx?symbol=US:GM&feed=OBR&date=20090427&id=9841064

With the icons of American economy crippled—Wall Street, Main Street, Detroit—it bears going beyond the blow-by-blow and asking the deeper question: *why did this happen?* Misguided government policy, greedy bankers, and a Daedalian maze of financial products underpinning the mortgage market couldn't alone cause so many people to make so many reckless and *prima facie* absurd decisions.

2|| "Yuppie Food Stamps"

On November 17, 1981, buried in the business pages of the *New York Times,* was a brief item about a new tool for the rich and well-to-do. "The Chemical Bank will begin marketing a new, 'upscale' MasterCard later this week," the *Times* reported. The credit card in question was a vanity item if ever there was one (at least in 1981). It was given the then-prestigious title of "Golden MasterCard" and the bank's president told the *Times* that perhaps two percent of the nation's population would qualify for the card—and would then only be issued after a thorough vetting of the applicant's income, assets, and cost of living. And after being selected as one of society's chosen few, what was the reward? A gold card with a credit limit of $5,000.[18]

Twenty-eight years later, at the opposite end of the credit orgy era, the aristocratic air of Chemical Bank's Golden MasterCard is preposterous. Today, the *average* credit card debt of a household tops

[18] Figures and quotations from the article "Chemical Bank Has Gold Card," New York Times, November 17, 1981. Accessible online at http://www.nytimes.com/1981/11/17/business/chemical-bank-has-gold-card.html

$8,000[19] and a mere gold card is laughably déclassé. (If you want to prove your status by the color of your credit card, you'd be well advised to start at platinum and work your way up to diamond, titanium, centurion, or any number of other mineral-marketing word combinations chiseled into a polyurethane facade.) The credit card, and its requisite sidekick, credit-card debt, have become an institutionalized facet of American consumer culture. The numbers speak for themselves: Americans carry $2.56 trillion in consumer debt, a 22 percent increase since 2000; average household credit card debt is $8,565, up nearly 15 percent from 2000. Total household debt, including mortgages, credit cards, and all other loans, represents 19 percent of household assets—up markedly from 13 percent in 1980.[20] Americans carry an average of 5.3 all-purpose credit cards per capita (this includes only Visa, MasterCard, American Express, and Discover cards) and have seen their credit card spending and debt skyrocket in the last ten years (see Figure 2.1 below). The ubiquity of credit cards, credit card debt, and the consumerist lifestyle they enable has led Robert D. Manning, a sociologist and expert on credit card usage, to term credit cards yuppie food stamps.

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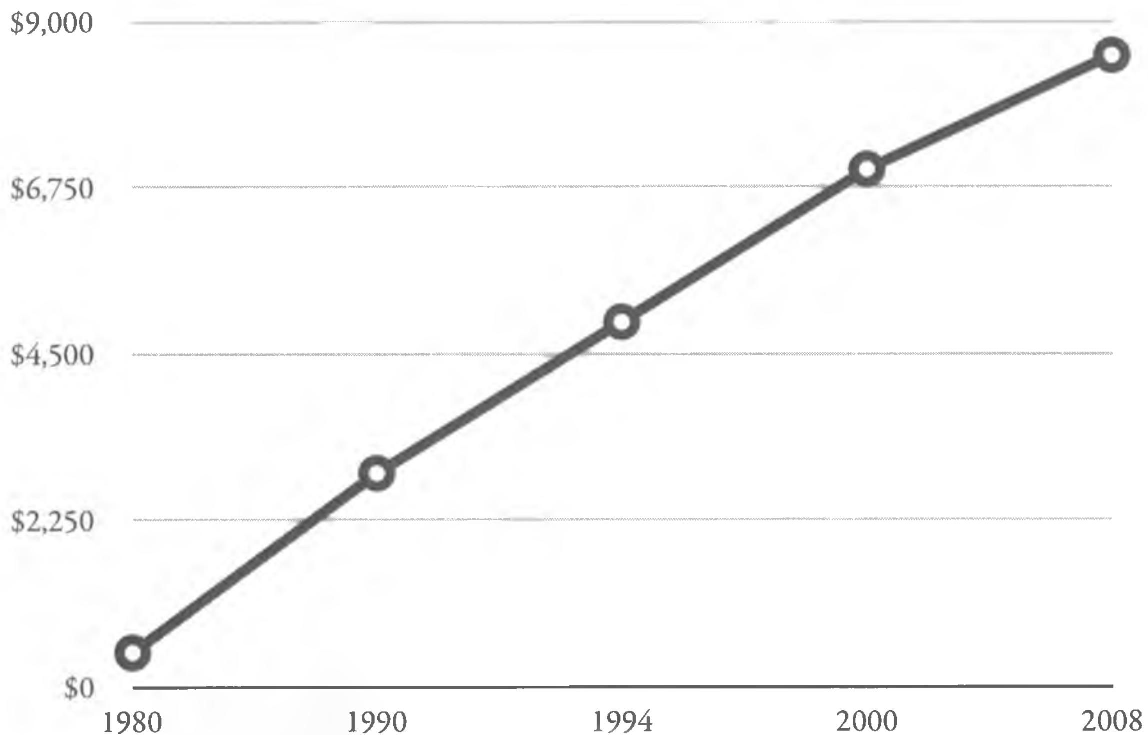
[19] Data as gathered by the Federal Reserve Bank and reported in "The Debt Trap" series in the New York Times in July 2008. Article accessible online at http://www.nytimes.com/2008/07/20/business/20debt.html?pagewanted=3

[20] *Ibid.*

FIGURE 2.1: Household Credit Card Debt (inflation-adjusted, 2008 dollars)

source: Credit Card Nation, the New York Times



At $2.56 trillion, American consumer debt is massive, but it pales in comparison to the more than $10 trillion worth of mortgage debt that Americans owe. Given the havoc wreaked by the mortgage crisis, one might think that it would be more instructive to train one's focus on the mortgage mess when looking for explanations. But that is simply not possible: mortgages and credit card loans have cross-pollinated and contaminated the financial system together: in the past decade, all kinds of financial products allowed borrowers to consolidate credit card loans by borrowing against the value of their houses (a home-equity loan), or to refinance their existing mortgage and assume the credit card debt as part of the mortgage, or to take out a second mortgage on a property to pay off credit card and other debts. So while the financial product may be a mortgage, it does not necessarily mean that the payments are only for a house. Conversely, the mortgage crisis has increased reliance on credit cards for many to meet day-to-day expenses. This has manifested itself

in two ways: homeowners who have seen their adjustable rates increase (meaning that monthly mortgage payments can double or triple) spend all or nearly all of their take-home income to make mortgage payments, necessitating the use of credit cards for other needs. Credit cards have also filled the void that home equity used to fill: with a mortgage worth more than the value of the house, a homeowner cannot tap his equity as a source for cash and must turn elsewhere for a loan—to his credit card.

FIGURE 2.2: 2008 U.S. Household Debt (averages)

*figure too small to be illustrated on chart

START YOUNG

It is said that if you want to understand a society's future, look to its youth. While the data shows that it is without doubt the baby boomer generation that kicked off the debt-fueled binge of the last quarter century, today's young adults are following proudly in their parents' footsteps. The $5,000 Golden MasterCard for aristocrats of 1981 is antiquated to today's college student. Today's college student enjoys the purchasing power that surpasses that of the richest of the rich just a generation ago, thanks solely to his credit card. Two-thirds of college students have and use credit cards. College seniors who keep balances on their credit cards carry an average debt of $2,623. Freshmen—first year students who are typically 18 years old—owe an average of $1,301 if they carry a balance on their credit cards.[21]

While the amounts of debt are staggering—thousands of dollars owed by students who essentially have no income—their irresponsibility and cavalier attitude toward racking up debt is even more astonishing. According to a 2008 survey, college students piled up debt to fund inane purchases: Forty percent of students used their credit cards for weekends and pizzas, 55 percent funded their day-to-day expenses on plastic, and 25 percent used their credit cards to bankroll vacations. Forty-eight percent of the survey respondents indicated that they do not pay their balances in full every month[22]—meaning that the double-digit interest mounting on a student's thousand-dollar-plus debt more likely than not represents a long-forgotten Ultimate Meat-Lover's Pizza and a never-remembered spring break rampage in Cancun.

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[21] Figures taken from "The Campus Credit Card Trap" report and survey conducted by the U.S. Public Interest Research Group in March 2008. Complete survey available for download at http://www.uspirg.org/uploads/vm/ir/vmirZbG5OLxH2NPUxQENdA/correctedthecampuscreditcardtrapmar08all.pdf

[22] *Ibid.*

The American consumer is a study in contrasts. Just as surely as the collegiate cardholder will use his gold, platinum, or titanium card to make an ill-advised purchase, you can safely assume that the young scholar's acquisition of the elemental plastic was equally ill-advised. The data bears this out. Seventy percent of collegiate cardholders reported stopping at a table or kiosk on their university's campus where one could sign up or apply for a credit card—and be given a "free gift" for their effort. In return for applying for a credit card, students were given t-shirts, frisbees, stress balls, or vouchers for free food from fast food restaurants.[23] The lure of these items is hard to explain, but is nevertheless extremely effective. Even older students who have already had their finances ruined by credit cards seem not to be able to resist. Last year, a student told her experience to the *New York Times*:

> *Abigail D. Molina, a second-year law student at the University of Oregon, applied in 2007 for a Chase Visa offered at a tent outside a football game. In exchange, she received a blanket. "I mostly wanted the blanket," Ms. Molina said. She added that this was her second university credit card. In 1994, when she was an undergraduate at the university, she applied for a card at a booth on campus and then accumulated about $30,000 in debt, almost all of it on the card. In 2001 she filed for bankruptcy. Looking back, she said it was "shockingly easy" to get the card, even as a first-year student.*[24]

THE AMERICAN WAY

There's an old American tradition where a parent tells his college-bound child "Don't you ever do this"—*this* being myriad drug use, juvenile drinking games, or kerfuffles with the local law enforcement. The unspoken implication is that this is precisely the trouble the finger-wagging father got into decades earlier during his scholastic endeavors. So, in keeping in with this time-honored

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[23] *Ibid.*

[24] As quoted in the *New York Times* article "Colleges Profit as Banks Market Credit Cards to Students," December 31, 2008. Article accessible online at http://www.nytimes.com/2009/01/01/business/01student.html?_r=1&pagewanted=all

tradition, while parents across America are slapping their foreheads when they learn of their debt-ridden children's adventures ("He spent $2,000 on beer goggles! What's a beer goggle?"), it turns out that they themselves are far more guilty of financial recklessness than their amateur-by-comparison progeny. Credit card debt averages more than $8,000 per household, while the average student's credit card debt is around $2,000.

If parents think that a few hundred dollars' worth of pizzas racking up 19 percent interest on a credit card is absurd, they best look closer to home. Across the board, Americans use credit cards in ways that work against their financial self-interest. Of the roughly 78 million households that use credit cards, fully 57 percent regularly carry a balance, subjecting themselves to interest, fees and finance charges. (These types of cardholders—those who regularly carry balances—are called revolvers in the financial industry.) Households that regularly carry a revolving balance—that's 57 percent of households—carry credit card debt fully double the national average.[25] To make sense of these numbers, it means that while the average household's credit card debt is "only" $8,565, if a household is a revolver (meaning it uses credit cards as debt tools), then its total credit card debt surpasses $16,000 on average. But these numbers only begin to show how American consumers rely on deep debt to finance their lifestyles—and how it's become an accepted and expected part of the culture.

In 2004, 35 million cardholders paid only the minimum amount required on their credit card bill—an amount that is typically two percent of the total outstanding debt.[26] This means that if a revolver

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[25] Data taken from *Credit Card Nation* by Robert D. Manning (page 13).

[26] As reported in the PBS *Frontline* television program "The Secret History of the Credit Card" on November 24, 2004. Transcript accessible online at http://www.pbs.org/wgbh/pages/frontline/shows/credit/etc/script.html

has the typical credit card debt of $16,000, he pays only $320 per month toward the balance. However, if the cardholder is charged the average credit card interest rate of 14.17 percent[27] (which is unlikely, as revolvers almost always carry higher-than-average interest rates), he will accrue $196 in new interest charges every month, wiping off only $124 of his $16,000 debt every month (these figures assume an average interest rate; higher interest rates, which can reach as high as 30 percent for the riskiest and most indebted revolvers, effectively mean that making only the minimum monthly payment will lead to a net increase in the credit card balance). This example assumes that credit card customers are not using their credit cards to make more purchases every month and further increasing their balances—which of course they are. As revolvers spend more, the balances increase further and further, with high interest and low required payments making repayment of the debt a near-term impossibility for most. As out-of-control as the proposition sounds, it is the reality for 35 million cardholders. And when one considers that the annual saving rate for the American household is only $392, most revolvers have no hope of paying off their massive consumer debts without tapping other assets.

But even many revolvers who are not teetering on the brink of financial calamity regularly act decidedly against their financial self-interest when they use credit cards. "I could wipe out my debt [today]," one credit card holder told the PBS *Frontline* program in 2004—but he doesn't. Andrew Kahr, the founder and former CEO of Providian, one of the leading credit card issuers of the 1980s, is widely credited with creating some of the marketing and financial tools that led to the explosion of the consumer credit card industry in the 1980s and 1990s. It was Kahr who invented the two-percent minimum payment and other features that have made credit cards the most profitable

[27] As reported by indexcreditcard.com on May 4, 2009. Data accessible online at http://www.indexcreditcards.com/creditcardmonitor/

products in banks' portfolios over the last 20 years. Kahr's research showed that making only the minimum payment was psychologically satisfying: If the minimum payment was what was required to be paid, paying it meant that one was being prudent and responsible— that it "eased consumers'anxiety about carrying large amounts of credit card debt," as Kahr phrased it.[28]

BLAME AND EXCESS: TWO AMERICAN PASTIMES

There have been countless reports, articles, series, and television specials about the nonpareil evil perpetrated by credit card companies. It is true that credit card companies made practice of extending credit to those who had no hopes of responsibly using it or with the means of reasonably repaying their debt. And of course the credit card industry had a wellspring of tricks to use to further confuse and manipulate its customers: universal default, interest rates that change without warning, contracts written in legalese indecipherable to most readers—the list goes on. But the fact remains that it was American consumers who, when it came time to pay, handed over their credit cards to the cashier—it was no one else.

Defenses of the credit card industry from credit card executives may be self-serving—"We build cars that can go 100 miles an hour. But if the speed limit is never higher than 65, why don't we have a law that says you can't build a car that goes faster than 65?" says Kahr.[29] But Kahr has a point: banks have a fiduciary responsibility to their shareholders to raise share prices and maximize profits. Consumers have a responsibility to themselves to spend within their limits. Moral judgments aside, it is clear who failed to meet his responsibility.

[28] PBS *Frontline*, November 24, 2004.

[29] *Ibid.*

The history of America's illicit love affair with credit cards marches lock-step through the last quarter-century with its equally tempestuous relationship with mortgages, Wall Street debt tools, and general spree of consumption. Until the 1980s, the personal saving rate was high (averaging about 10 percent for throughout the post-World War II years[30]) and debt was low (with all debt—consumer, mortgage, and other types, averaging from 10 to 13 percent of total assets[31]). Consumer debt—and especially credit card debt—was a virtual non-factor on a household's balance sheet. If a consumer did hold any consumer debt, it was most likely owed to a department store or other retailer who sold big-ticket items like refrigerators and washing machines on low-interest credit as a way to boost sales.[32] But as the 1980s dawned, and the baby boom generation came to be the dominant force in the American marketplace, the penny-saved-is-a-penny-earned ethos that historically defined American attitudes towards work, thrift, and debt went by the wayside. Out was the Puritan work ethic and in was a generation that valued status, class, and excess as its guiding virtues. Proving that capitalism works, the generation hungry for status symbols and accumulation of things saw its demand met by a more-than-willing supplier: banks.

At the beginning of the consumerist binge, credit cards were more a status symbol than a tool for accruing debt. Consider the 1981 Chemical Bank Golden MasterCard, whose executives touted its exclusivity over its modest-by-today's-standard spending limit. By the late 1980s, the high end of the market was saturated, and bankers had discovered that the real money in credit cards was in the

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[30] Data from Personal Saving Rate as reported by the U.S. Department of Commerce's Bureau of Economic Analysis on April 30, 2009. Complete data accessible online at http://research.stlouisfed.org/fred2/data/PSAVERT.txt

[31] Data from the Federal Reserve Bank's report "Household Debt Service and Financial Obligations Ratio." Accessible online at http://www.federalreserve.gov/releases/housedebt/

[32] Manning, *Credit Card Nation,* p. 17

interest payments. Says Kahr, one of the pioneers of the 1980s credit card industry: "The high-balance accounts will be much more profitable than the low-balance accounts. . . .[b]ecause they're paying interest on a higher balance."[33] And so, in the late 1980s, banks began a full-throttle push into the vast middle and lower-middle class markets—those least likely to be able to pay off their credit card bills every month. At the beginning of the decade, a credit card ad was likely to resort to flattery and class aspiration—"There is a charge card that says more about you than anything you can possibly charge with it. . ."[34]—but by the closing years of the 1980s advertisements were more likely to be targeted much further down the socio-economic ladder. A new breed of credit card promised discounts at Comfort Inn motels, Red Lobster restaurants, K-Mart, Woolworth, and Montgomery Ward. The credit card ceased to be a status symbol and was well on its way to becoming an expensive crutch for the middle classes to finance its lifestyles.

But even as credit cards became universally available and became widely used by the middle and lower-middle classes, their relationship with class aspiration never disappeared. In fact, when credit cards ceased being the exclusive domain of the well-off, credit cards' role as equipment in the status game became more important: It was now possible for people to easily buy things beyond their means, giving their status an instant boost. Jay Leno, the bellwether comedian of questionable hilariousness, proved that the credit cards and class consciousness could cut both ways, when upon the introduction of a K-mart-branded credit card in 1995 he quipped, "now we know why the K-

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[33] PBS *Frontline,* November 24, 2004.

[34] Text from an American Express advertisement in a 1981 issue of *Time* Magazine for its Gold Card. As cited in Manning's *Credit Card Nation*, p. 25.

mart credit card was created: so that people with Discover [credit cards] have someone to look down on. . . .Don't leave your mobile home without it."[35]

Leno's joke was good for a laugh, but it skewered few people. The magic of credit cards is that they enabled large swaths of the middle class—who without credit cards would otherwise be relegated to shopping at low-end discount stores like K-mart—to move up a step on the class ladder without ever paying for it—at least in any tangible currency. By the mid-1990s, with even the middle- and lower-class credit card markets saturated, credit card companies' strategies shifted to encouraging more spending on credit cards and encouraging consumers to hold larger balances. This strategy gave birth to the famous "priceless" MasterCard advertising campaign. The MasterCard advertisements were shameless in playing on middle-class consumers' aspirations to wealth and the trappings thereof. The ads promised that with MasterCard anyone could live the lifestyle of the extremely wealthy:

> *Dinner for 37, Chez Marcella: $2,416*
> *One happy-50th-birthday card: $1.95*
> *One leopard-print peekaboo nightie: $45*
> *Still being able to make her blush: priceless*
>
> *There are some things money can't buy. For everything else, there's MasterCard. Platinum MasterCard has a high spending limit for the things that matter.*[36]

The advertisements played on an already eager-to-prove-one's-status mentality that dominated the boom of the late 1990s (see Chapter 3 for a more detailed examination of the consumer mindset), but were only half of the equation in getting Americans to use even more credit. The second part of

[35] Manning, p. 25

[36] Manning, p. 28

the equation was to make debt seem and feel cheap without it actually being cheap. This was accomplished by ensuring that there were no short-term and very few medium-term consequences for consumers running up a credit card tab. Beginning in the late 1990s, Americans were flooded with offers for credit cards with zero-percent introductory interest rates. "You're Pre-approved!" the envelope from the bank would read. To accept the offer and get a brand-new credit card, all the recipient would have to do is mail back a slip of paper with the "I accept" box checked (the postage was naturally paid for by the bank), and within a few weeks, he would have a shiny new piece of plastic, with which he could rack up purchases and be charged no up-front interest. The interest-free period, of course, would end in six months or a year; then double-digit interest would start to accrue. Consumers were able to run up large debts on new credit cards without feeling any consequences for months or even a year, but when the honeymoon period ended, they found themselves with painfully large debts—and the banks found themselves with a long-term source of revenue. It was in the late 1990s that most banks lowered their minimum payment requirements from five percent of a total balance to two percent. At the same time, credit limits skyrocketed. [37] Less debt being repaid every month and more total debt being accrued was a formula for higher interest payments—and higher bank profits.

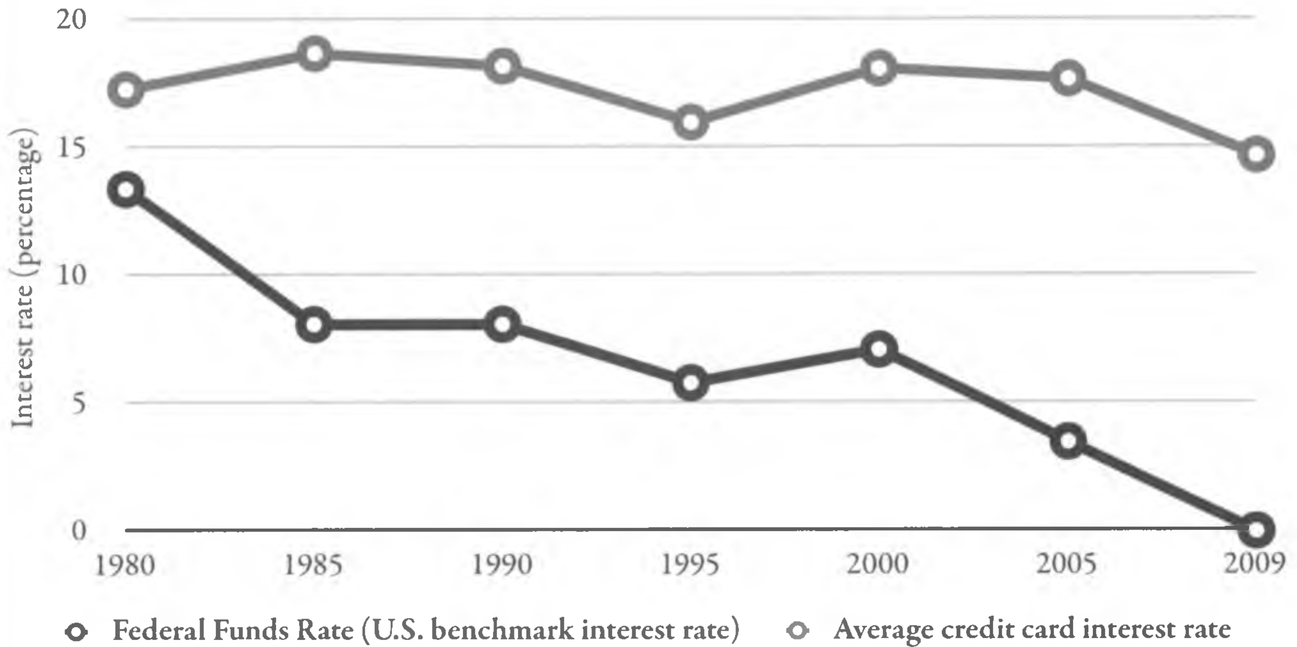
At the turn of the millennium, the credit card craze began to merge with the mortgage madness. As the 2001 recession hit, many cardholders were forced to come to terms with their large credit card debts. The tech bubble may have burst, but the real estate bubble was rapidly inflating. It was from 2001 to 2006 that consumers began treating their homes much as they treated their credit cards—as piggy banks. Even as interest rates plunged during the housing boom, making mortgages and a host

[37] PBS *Frontline,* November 24, 2004.

of other loans cheap, consumers continued to rack up credit card debt in record amounts. This was a godsend to the banks: unlike nearly every other type of loan, credit card interest rates were unmoved by changes in the Federal Reserve Bank's benchmark interest rates (see Figure 2.3).

Some homeowners whose financial situation forced them to address their credit card debt consolidated their debts—combining tens or hundreds of thousands of dollars' worth of credit card debt and their outstanding mortgage payments into one monster home-equity loan. Such a loan was possible because the homeowner was able to borrow against the equity he held in his house, which had doubtless increased in the real estate boom of the early 2000s. Other consumers were unconcerned about their credit card debt, secure that the sure-to-rise value of their homes insulated them from the absolutely-positive-to-rise debt mounting on their credit card. (This was an especially absurd decision to make, as credit card interest rates remained constantly high regardless of interest rates, which approached historic lows during the 2000s; see Figure 2.3). A third group had no strategy at all: spend now, worry later.

FIGURE 2.3: Historic Relationship Between Interest Rates and Credit Card Rates



Sources: *Credit Card Nation*, the *New York Times*, indexcreditcard.com, Federal Reserve Bank Open Market Committee

MORTGAGE MARKET RACES TO THE BOTTOM

Credit cards started their existence as the preserves of the rich and expanded to the middle and then lower classes before reaching ubiquity. A generation later, mortgages would follow the same path. Home ownership has long been a key part of the American dream—both real and idealized. In the half-century following World War II, the real American dream followed a familiar script: save money, start a family, take out a mortgage, make a down payment, and buy a house. For fifty years, this offered a stable, profitable and not very risky model for banks loaning money for mortgages. Sure, interest rates changed with the market, but for decades, the mortgage business was a boring and predictable operation: a large down payment on the property was required (10 to 20 percent was a common standard), and a fixed interest rate was locked in for the life of the mortgage (typically

20 to 30 years). Mortgages were a staid affair that required significant discipline from the buyer: a hefty savings for the down payment, prudent budgeting to make payments over the decades-long loan term, and a good credit history to pass muster with the bank that would give you the mortgage.

By 2000, anyone who wanted a credit card could easily get one. Not to be outdone, mortgage lenders saw to it that virtually anyone could get a mortgage. Just as the vetting process to ensure that only the cream of society was able to carry a gold card fell by the wayside in the 1980s, the vetting to ensure that the person buying the McMansion actually had the means to live in his new house disappeared shortly after the turn of the millennium. (The social factors driving people into bigger and more luxurious houses will be examined in Chapter 3.) By 2006, 20 percent of the mortgages being given each year fell into the sub-prime category.[38]

In the early 2000s, when banks began extending mortgages to customers whom they previously would have laughed out of their offices, they were operating under two assumptions that seemed to ensure any loan, no matter how risky, would yield big profits: 1. The value of real estate was an ever-increasing quantity, and 2. Banks would be able to sell the loan easily on the secondary market. Both of these assumptions served to separate the bank from the risk of the loan. Because the mortgage would not be on the bank's books for more than a few years at most, the long-term profit of the mortgage was not of immediate concern—only short-term profits. Indeed, this accomplished utopian results—at least until the real estate market crashed: homeownership was democratized like never before and bankers from the local branch all the way to Manhattan skyscrapers made

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[38] According to data from *Inside Mortgage Finance* as quoted in an article on National Public Radio's Web site on March 23, 2007. Article accessible online at http://www.npr.org/templates/story/story.php?storyId=9085408

enormous bonuses and commissions on the rash of mortgages being written in the boom real estate market.

In order to facilitate the rush of homeowners deemed unqualified under the old regime, several new types of mortgages were created and popularized during the housing boom of the new millennium. Because they had little or no savings, mortgages requiring no or token down payments became *de rigueur* for the new class of homebuyers previously known as unqualified. But mortgages were not to be given to those only who didn't have the means to make a down payment—they were to be given to those who couldn't make the monthly mortgage payments. Thus, another must-have feature for the new class of homebuyer was an adjustable interest rate. (Adjustable-rate mortgages encompass many different types of mortgage. A mortgage has an adjustable rate if its interest rate varies throughout the term of the loan. A mortgage with a constant interest rate throughout its term is called a fixed-rate mortgage.) Adjustable-rate mortgages function much like the credit cards with zero-percent introductory interest rates: the borrower pays very low interest rates for the first part of the mortgage (typically five years), after which the mortgage resets (the interest rate changes) to an interest rate that is usually not determined until well after the mortgage is signed. For many homebuyers, there was no plan for when the interest rate reset: they wanted a house, the bank wanted them to have the house—end of story. But for the deeper thinkers, there was a plan—predicated, as always, on infinitely rising real estate values. When the interest rate reset, the homeowner would take out a new mortgage to pay off the first one, using the equity in his house (which was supposed to be worth more) to finance the second mortgage. When housing prices fell and interest rates reset, the default and foreclosure epidemic began.

But unqualified homeowners had a smorgasbord of options to choose from to finance their dream homes. Interest-only mortgages, an even more liberal variant of the adjustable-rate mortgage, allows borrowers to pay only the interest on the borrowed amount for a set period—the principal does not typically need to be repaid for five to ten years. Such a loan put nearly any house within the reach of anyone. With a 5 percent interest rate (about average for the 2001-2006 period) a $500,000 house could be had with no down payment and payments of only $69 per month. The notion is fantastic, but millions of homes were bought this way. The strategy for these homebuyers who could otherwise never come close to affording such houses was always the same: when the money comes due, borrow against the sure-to-appreciate value of your unaffordable house.

The now-infamous sub-prime type of mortgage is the classification given to the riskiest types of mortgages given to borrowers with extremely bad credit history. (The hard definition of a sub-prime loan is a loan given to someone with a FICO score below 620.) The sub-prime mortgage was ubiquitous among the legions of the previously unqualified and almost always made use of at least one of the tools to allow a borrower to buy a house with a very small up-front payment. (Sub-prime mortgages usually use several of these tools, for example, no down-payment and an adjustable-rate mortgage with a very low initial interest rate; 80 percent of sub-prime mortgages have adjustable interest rates.[39]) While the sub-prime mortgage has received a terrible name, it merely refers to the fact that the borrower is among the most risky (i.e., least creditworthy). A sub-prime mortgage does not by itself connote risky terms—only a risky borrower.

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[39] According to Susan Wachter, a professor of real estate the University of Pennsylvania's Wharton School of Business as quoted on National Public Radio's Web site on March 23, 2007. Article accessible online at http://www.npr.org/templates/story/story.php?storyId=9085408

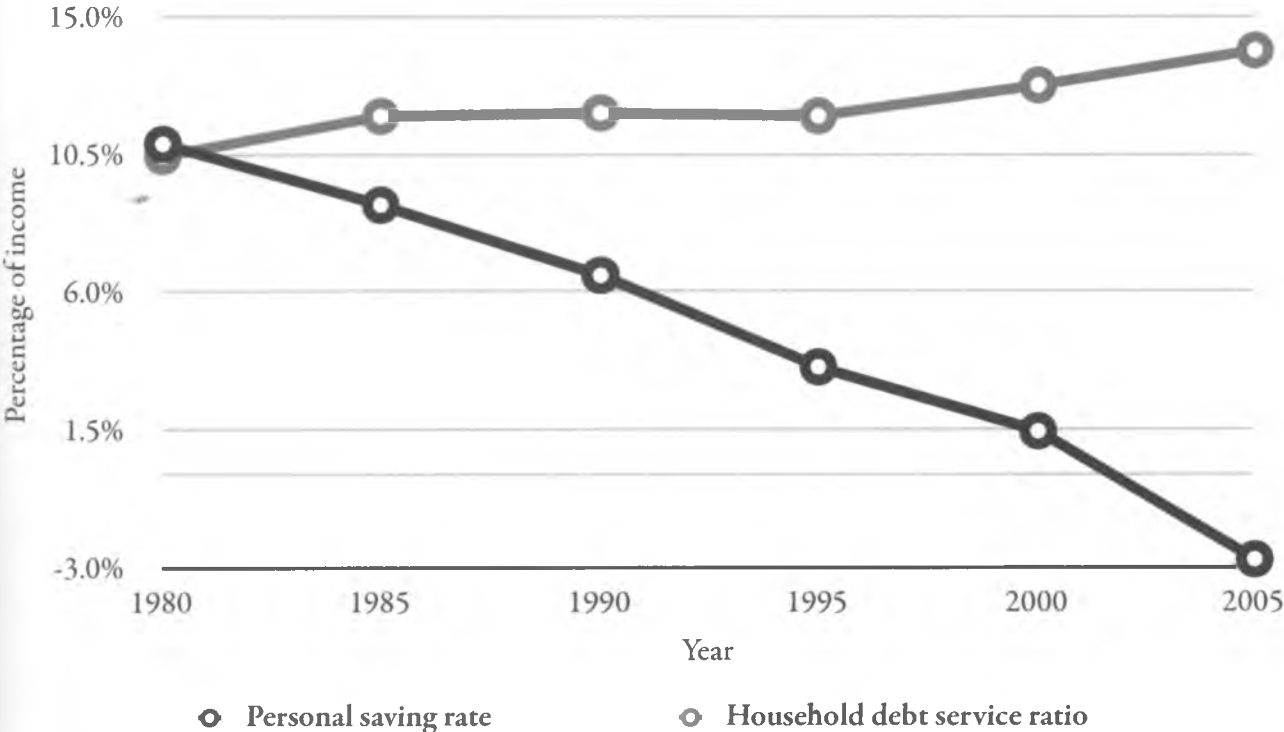
Alt-A mortgages are the second-most common classification of mortgages given to borrowers of dubious credit. A step between sub-prime and prime (i.e., traditionally creditworthy) borrowers, Alt-A mortgages were typically issued to borrowers with decent credit histories, but for myriad reasons, would not qualify for a traditional loan. One appeal the Alt-A held was that information about income, assets, liabilities were not required to be reported in order to gain approval. Given that one had a respectable credit history, it would be possible to borrow well beyond his means by merely omitting the detail from his application. For this privilege he would receive a higher interest rate than a prime borrower, but that was a small price to pay—he was instructed to turn to the flip-or-borrow-against-equity strategy that was the catch-all solution to making homeownership as easy as charging something to a Visa card.

3|| A Culture of More

Beginning in the early 1980s, American consumers were armed with debt vehicles like never before. The grim economic numbers explored in previous chapters show that Americans amassed mind-boggling amounts of consumer and mortgage debt. But the debt is the painful side of the story—the end of the story. The beginning of the story a much happier one and one that is integral to understanding the American dream: buying things. By nearly every measure, Americans are buying many more things than they did a generation ago. And not only are they buying more, the things they're buying are bigger, faster, and more obtrusive. New product categories have been created—sport utility vehicles, premium bottled water, day spas—that a generation ago did not exist

beyond the preserve of the very rich, but are now staples of the middle-class lifestyle. Indeed, a trip through contemporary suburbia would not be complete without encountering SUV after SUV (whose prices for non-luxury models typically range from $28,000 to $42,000), and day spa after day spa (whose services typically cost upwards of $100 per hour). But a drive through suburbia would truly be incomplete if one did not notice that houses are now gargantuan compared to those built a generation before—and, in keeping with the times, pack in nearly every faux luxury imaginable.

FIGURE 3.1: Household savings vs. debt (as a percentage of income), 1980-2005



source: Federal Reserve Bank

HOME SWEET STATUS SYMBOL

"People who buy something they cannot afford usually hear a little voice warning them away or prodding them to feel guilty. But when the item in question is a house, all the signals in American life conspire to drown out the little voice," wrote financial journalist Michael Lewis in a 2008 *Portfolio* magazine article examining the fallout of the mortgage crisis. "More than any other possession, houses are what people use to say, 'Look how well I'm doing!' Given the financial anxieties and indignities suffered by the American middle class, it's hardly surprising that a lower-middle-class child who grows up in a small house feels a burning need to acquire a bigger one. The wonder is how an upper-middle-class child who grew up in a big and perfectly enviable house is inexorably drawn to a mansion."[40]

Lewis states implicitly what is an explicit truth: In American society, the house is the ultimate status symbol. There are many factors at work that fuel the insatiable American consumer appetite; nearly all were at work in the 25-year craze that saw Americans borrow to buy bigger and ever more extravagant homes. Harvard professor Juliet B. Schor has written extensively on American consumerism. In her book *The Overspent American,* she defines American consumerism succinctly: "How we spend has become a crucial part of our self-image, personal identity, and social network."[41] With consumption playing an all-important role in determining one's worth in American society, Schor identifies a pattern she describes as "upscaling"—or spending above one's means in order to meet class expectations (of either their own or others' construction).

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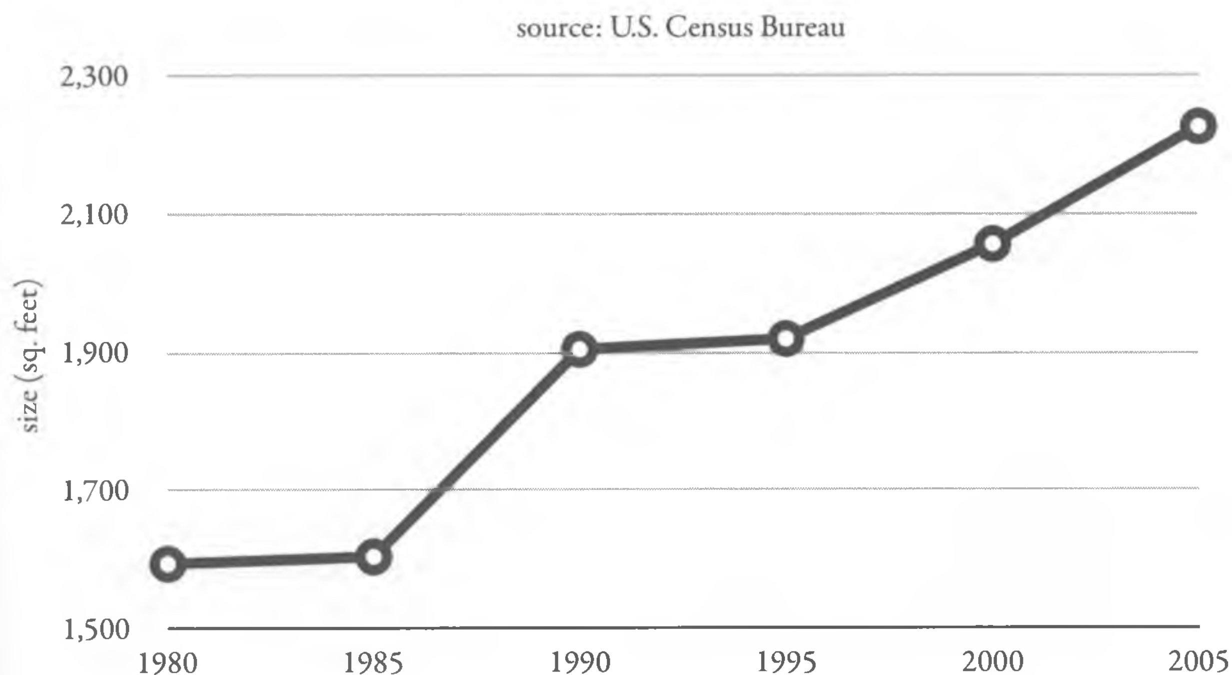
[40] "The Mansion: A Subprime Parable," *Portfolio,* October 2008. Article accessible online at http://www.portfolio.com/culture-lifestyle/goods/real-estate/2008/09/18/Michael-Lewis-Mansion?page=0

[41] *The Overspent American,* by Juliet B. Schor, p. 96

The American dream holds that one ought to live better than his parents' generation. Constant improvement and tangible confirmation of such is part of the American ethos. To tread water in American society is to fail; Americans thrive on bigger, higher, and faster. Such an ethos has led America to amazing achievements: its status as a magnet for talented immigrants and its twentieth-century innovations in science, business, and entrepreneurship can all be traced back to the bigger-higher-faster. But when coupled with its late-twentieth century *consumption über alles* mindset, this ethic has led to disgusting developments. Bigger, higher, faster used to stand for what America was best known: innovation—airplanes, skyscrapers, automobiles. Today, its best application is to what today's America largely stands for: gluttonous excess—bigger houses, higher debt, and faster gratification.

FIGURE 3. 2: Average size of newly built houses (sq. feet), 1980-2005



No other single item in America says as much about a person as does his house, which explains why Americans spent so high above their reach to buy houses so far beyond their means. The size of the average new home built in America metastasized 40 percent over the 25-year period from 1980 to 2005 (see Figure 3.2). Houses grew from a modest 1,600 square feet to more than 2,200 square feet, with McMansions replete with two-story ceilings, "great rooms," and granite counter tops becoming the new standard among class-conscious and class-aspirant middle-class suburbanites. Fantasies "reveal the centrality of gaining others' esteem," writes Schor in her analysis of homebuyers' motivations. "The ideal house fantasy is not complete without 'showing the house to admiring others.'" A homebuyer whom Schor interviewed told her this: "The awe and respect and wonder of my guest are basic to every daydream about my house."[42] Respect, approval, and acknowledgment are at the root of Americans' preoccupation with consumption, and as Schor's interviews prove, houses are at its center.

Michael Lewis marvels at the absurdity: even as it has become obvious that tens of millions of Americans have spent beyond their means—nearly ten percent of all mortgages are either past due or in foreclosure—the American dream of bigger-higher-faster homeownership refuses to die. Writes Lewis:

> *The tax code tells people [who took out mortgages high above their means] that while their [newly reset adjustable-rate] interest payments are now gargantuan relative to their income, they're deductible. Their friends tell them how impressed they are—and they mean it. Their family tells them that while theirs is indeed a big house, they have worked hard, and Americans who work hard deserve to own a dream house. Their kids love them for it. Across America, some version of this drama has become a social norm.*[43]

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[42] Schor, p. 71

[43] "The Mansion: A Subprime Parable," *Portfolio,* October 2008. Article accessible online at http://www.portfolio.com/culture-lifestyle/goods/real-estate/2008/09/18/Michael-Lewis-Mansion?page=0

BLIND LEADING THE BLIND

Fanciful aspirations of consumerism may have been fulfilled through the massive use of myopic mortgages and easy credit cards, but the story is deeper than that. The story of America's quarter-century of excess is a human story. Americans consumed beyond their means for human reasons—acceptance, indulgence, the illusion of success. When it came to the millennial obsession with bigger-higher-faster homeownership, the first face a prospective homebuyer could expect to encounter would be a real estate agent.

With the real estate market at historic highs in the early 2000s, the idea that everyone could own a home being a near universally held belief, and dubious mortgages easily available, it was boom times for real estate agents. High property prices meant high commissions and easy mortgages available to nearly anyone expanded their client base like never before. Many real estate agents took to cold-calling prospective clients and asking if they were interested in buying a house. When the prospective client asked how he would pay for it, "talk to my mortgage guy" was more often than not the answer—the real estate agents were often no better versed in the mechanics of mortgage finance than their barely qualified clients. It was the blind leading the blind.

But it was not only the real estate agent and his client who was visually impaired—the "loan officer" processing the mortgage application was more likely to be a call-center employee than a banker in any traditional sense of the term. Everyone was following protocol, everyone was making money, and no one knew what he was doing.

"I'd lie if I said every piece of documentation was properly signed and dated," a supervisor at a Washington Mutual mortgage processing center told the *New York Times* in 2008. Washington Mutual, one of the largest issuers of adjustable-rate and sub-prime mortgages—and one of the highest-profile casualties of the mortgage meltdown. The supervisor tells the *Times* of a culture where loans were expected to be approved ("the power of yes," went the bank's credo), and employees who became angry when too many questions were asked. When asked if a mortgage applicant were qualified for a mortgage—or if the information on the application were accurate, another Washington Mutual mortgage officer told the *Times,* "We were told from up above that that's not our concern. Our concern is just to write the loan."

A third Washington Mutual mortgage officer told the *Times* of how employees handled a typical mortgage application: Most loans required only an address, Social Security number, and a statement of income and assets—with no verification. She would then process the application through the bank's computer system for approval. If the computer were unable to give instant approval, she would have to consult another loan officer—which threatened to complicate the loan's approval should any unpleasant details emerge. "They would be furious. They would put it on you, that they weren't going to get paid if you stood in the way."[44]

Of course, everyone stood to win big in the short-term: The homebuyer got his loan and a huge new house, regardless of whether he was qualified; the call-center-employee-cum-mortgage-officer made thousands of dollars in commissions on the loans he processed, and the clueless real estate

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[44] As reported and quoted in the *New York Times* article "Saying Yes, WaMu Built Empire on Shaky Loans," December 27, 2008. Accessible online at http://www.nytimes.com/2008/12/28/business/28wamu.html?pagewanted=all

agent who referred his client to the bank made a huge commission on the home sale, and often made even more money on a commission for referring her client to the bank. In the case of Washington Mutual, some real estate agents collected referral fees of more than $10,000 from the bank.[45]

But for all the insanity in among mortgage lenders, banks, and real estate agents, it is imperative to remember that it was consumers buying something that they could not afford. "Fantasy descriptions of ideal houses often sound like commercials," writes Schor.[46] American consumers, true to their acquisitive nature, opted to select fantasy over financial reality. Says Lewis:

> *It's no good pretending that Americans didn't know they couldn't afford such properties, or that they were seduced into believing they could afford them by mendacious mortgage brokers or Wall Street traders. If they hadn't lusted after the bigger house, they never would have met the mortgage brokers in the first place. The money-lending business didn't create the American desire for unaffordable housing. It simply facilitated it."*[47]

AN ALL-CONSUMING URGE

McMansions for $69 a month were by far the most flagrant and ostentatious manifestations of Americans' surreal and out-of-control consumerism, but were hardly its only example. Indeed, for decades, American society came to be defined more and more by its consumerist proclivities. It is instructive to notice the similarities between the fantastic mortgage lending and spiraling credit card debt: banks that asked few questions of borrowers, consumers consumed by bigger-faster-higher

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[45] *Ibid.*

[46] Schor, p. 70

[47] "The Mansion: A Subprime Parable," *Portfolio,* October 2008. Article accessible online at http://www.portfolio.com/culture-lifestyle/goods/real-estate/2008/09/18/Michael-Lewis-Mansion?page=0

fever, and a system that required no short- or medium-term repayments. It was a perfect system for unleashing Americans' raw consumerism.

By the late 1980s, crass consumerism so thoroughly dominated the culture that a game called Mall Madness became one of the day's most popular children's board games. "Introduced by Milton Bradley in 1989, for players '9 years and up,' it promotes instant gratification and unrepentant consumption, the antithesis of the cultural values inculcated in the preceding generations of Monopoly aficionados," writes Manning in *Credit Card Nation.*[48] The game's theme is exactly as its name implies: "Now you can shop till you drop as you rush from store to store. [The] object of the game [is to] be the first to buy six items on your shopping list and get back to the parking lot," the instructions state. After depleting his or her initial $200 shopping money players "have to go to the bank to get more money. . . .[by] insert[ing his] credit card[s] into the bank slot. The voice will tell you to take $50, $75, or $100."[49]

Juvenile the Mall Madness example may be, but it is illustrative of the juvenile wave of excess—and celebration of excess—that dominated the American culture going back to the Reagan era. Television ads—most famously, the MasterCard "priceless" campaign discussed in the previous chapter—encouraged lavish consumerism, but Americans didn't require advertisements to spur on their avarice. Part of the consumerism was a reflection of traditional American values. Describing what she terms the "escalation mentality," Schur writes "market imperative is bigger, better, more. . . .We expect our standard of living to rise annually, and throughout our working lives. . . .It

[48] Manning, 112

[49] *Ibid.*

is progress." But how fast one's standards should rise, and to what meteoric level, was a complete fantasy—a fantasy enabled by decades' worth of debt and encouraged by a materialistic culture.

In several surveys, American consumers have all but admitted to rampant greed and out-of-control spending. In one survey, 61 percent of consumers responded that they "always have something in mind that they look forward to buying." 27 percent said that they "dream about things they do not own very often." Asked in the same survey what "things...you would like to own or do someday," respondents were able to reel off well-rehearsed wish lists, averaging 6.3 items. Material goods outnumbered intangible or idealistic goods by a three-to-one ratio. 67 percent of respondents wanted an exotic vacation, 47 percent wanted a bigger or better home, 42 percent a new car (usually a luxury model), 28 percent wanted a vacation home. The survey respondents were nothing if not rational economic actors: far fewer wanted smaller-ticket items. About a quarter wanted big-screen televisions and computers. 15 percent wanted a boat, and ten percent wanted a new clothes. But perhaps the most enterprising were the 16 percent who flat asked for money—so as to buy whatever they wanted.[50]

In a separate survey, Americans lamented their lack of financial discipline, but stopped well short of pointing the finger of blame at themselves. In a 1995 survey, 65 percent of respondents agreed that "looking back on my spending, I often wonder where the money goes" (18 percent of the respondents strongly agreed). 70 percent of the sample described "the average American" as "very

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[50] Survey conducted by Susan Fournier and Michael Guiry as part of a study of inner desire. As described in Schur's *Overspent American*, p. 70

materialistic," but only eight percent said they were materialistic themselves, clearly demonstrating the gulf between fantasy and reality on the touchy subject of personal finance.[51]

PLAYING THE PART

Consumption and excess in America are both glamorized and expected. It's a strange duality that never leaves one satisfied with his social lot. Americans take their social cues from many places: their neighbors, their co-workers, their friends, television, popular culture. Competitiveness defines the ways people consume within a peer group—the phenomenon of keeping up with the Joneses. But American consumers take their cues not only from their immediate social circle, but from society at large. The result: an all-out attack on the avaricious consumer's "worth" from every direction. Walking down through the office with a plain styrofoam coffee cup won't suffice; a four-dollar Starbucks cup is necessary. All of your kid's classmates' parents are now driving big sport utility vehicles, so you must of course prove you're no less than them; now you have a $40,000 new car. The neighbor just put a pool in his backyard; it won't be long before you do. It is bad enough that such petty competition among supposed friends and acquaintances defines their relationships. But further complicating matters is the role of society as a whole. And no part of society plays as destructive a role in glamorizing the cult of consumption as television.

Turn on a television to any American program and you are likely to see an all-out celebration of avarice. While television has always portrayed people as richer than they are, the explosion in the popularity of reality shows has driven the trend toward the perverse. Reality programs like *The*

[51] Data from a survey conducted on 80,000 employees of an unnamed major telecommunications company in 1994 and 1995. As described in Schur's *Overspent American*, p. 83

Apprentice (featuring Donald Trump), *The Simple Life* (starring Paris Hilton), and a plethora of their ilk glorify greed, consumption and hedonism. When participants on reality shows—which, after all, are supposed to reflect reality—burn through $50,000 as if it were nothing, it reinforces the idea that everyone is entitled to the finer things. *If some idiot on TV can have this, why can't I?* the thinking goes. One study by consumer researches Thomas O'Guinn and L.J. Shrum proves as much. Their study showed that the more television one watches, the more one misjudges how common many luxuries are. The study showed that the amount of television watched has a direct relationship with how common consumers think houses with tennis courts, private planes, maids, and swimming pools are among the population. Also affected: the number of millionaires in the population and how common plastic surgery is.[52]

With psycho-social attacks coming from every direction, the class-conscious consumer chooses again and again to act against his own self-interest. He buys the big house with a house-of-cards mortgage and lives the good life with credit cards racking up tens of thousands of dollars in debt. But debt is not the only way he can use his consumerism to shoot himself in the foot. Along with the McMansion the late 1990s and early 2000s, sport utility vehicles became the must-have accessory for the class-conscious middle-class suburbanite. SUVs became so popular that by the early 2000s, they captured nearly 20 percent of the U.S. auto market.[53] A grumbling suburban status symbol embodying the bigger-higher-faster ethos of millennial America, SUVs were celebrated symbols of suburbia until oil prices spiked in 2008, making many SUVs prohibitively expensive to keep fueled. In the spring and summer of 2008, stories abounded of SUV owners trading in their

[52] Schur, p. 80

[53] Data from Automotive Digest, May 2007. Accessible online at http://www.automotivedigest.com/content/displayArticle.aspx?a=56381

vehicles at substantial losses for more practical cars. The new status symbol in the wake of $4 gasoline? The Toyota Prius, a mid-size electric hybrid car capable of getting 50 miles per gallon. Waiting lists at dealers regularly ran six months.

4|| The Debt Industry

While the orgy of consumerism unfolded on Main Street beginning in the 1980s, contemporaneous developments on Wall Street were revolutionizing the way investors treated debt. Spurred on by several waves of deregulation, the invention of incredibly creative financial products, and the radical consolidation of the banking industry, Wall Street laid the groundwork that produced fat profits for a generation, created the caricature of the over-the-top greed-possessed New York banker, and changed the way investment markets work. But even all-powerful Wall Street could not escape the disastrous consequences of unbridled American consumer excess—a monster that it helped create and keep well fed.

Wall Street, as it is popularly understood—the preserve of those with elite educations, six- and seven-figure salaries, and a uniquely brash brand of avarice—is a creation no more than a generation old. For nearly 50 years after the 1929 stock market crash, working in risky finance was seen as a somewhat ignoble profession. The Wall Street of the 1970s was a comparatively sleepy address compared to the investment banking industry known today. Jobs on Wall Street were not especially prestigious, the pay was not phenomenally high, and what money there was to be had

was to be found in stocks, equities, and trading corporate and government bonds. If one thing can be said to have facilitated the created the now universally understood stereotype of the arrogant, avaricious, and extremely rich Wall Street type, it is the now infamous mortgage-backed security.

The mortgage-backed security, hatched in the waning days of Jimmy Carter's inflation-plagued 1970s, came to be the most important financial product of the early 1980s, driving record profits to the investment bank that pioneered the product, and almost singlehandedly turning Wall Street work from a slightly unseemly vocation into the chosen profession of the elite. Michael Lewis, now a highly regarded financial journalist, wrote a memoir called *Liar's Poker* in 1989, a seminal account of the Wall Street of the 1980s. The memoir recounts Lewis' three years at Salomon Brothers, a then-high-flying investment bank, but more notably, the firm that created and pioneered the mortgage backed security. "[I]n 1978 on Wall Street it was flaky to think that home mortgages could be big business," Lewis wrote. "Everything about them seemed small and insignificant." Seven years and more than $600 million in profits later (from the mortgage-backed securities division at Solomon alone), it was the Wall Street consensus that the small group of investment bankers involved in selling mortgage-backed securities were "perhaps the most profitable corporate employees in America."[54]

THE INVENTION OF THE MORTGAGE-BACKED SECURITY

The mortgage-backed security owes its creation to the particularly dismal economic climate of the late 1970s and the unmatched creativity of a small band of Wall Street investment bankers. By

[54] *Liar's Poker* by Michael Lewis, p. 82

1980, the U.S. mortgage market had surpassed the American stock market to become the largest capital market in the world.[55] Until that time, however, the mortgage market had been the sole domain of savings banks and savings and loan associations (also referred to as thrifts)—usually small, not well-capitalized, and local. But the then-more than $1 trillion mortgage market was beyond the reach of the Wall Street traders. Mortgages represented real property, not the paper certificates that were the currency of Wall Street. But the $1 trillion-plus value of the mortgage market made it a tempting target for Wall Street. The solution, as history records, was securitization and the creation of the now-infamous mortgage-backed security. While mortgage-backed securities' current inglorious fame has made the product a household term, 30 years ago the concept was groundbreaking and met with great skepticism among the then-rulers of Wall Street. The most daunting challenge was how to buy the mortgages in the first place. The mortgage market was then dominated by thousands of small, local, and unsophisticated-by-Wall-Street-standards savings and loans whose lifeblood was their mortgage portfolios. But 30 years ago, times were especially bad for savings and loans, and, for many, securitization turned out to be their saving grace.

The late 1970s and early 1980s, were disastrous years for the savings and loan industry. Between 1980 and 1983, nearly a quarter of the country's 4,002 savings and loans collapsed.[56] Hardest hit of all were the thrifts' mortgage lending divisions, which ground to a near halt amidst an environment of sky-high short-term interest rates that made long-term loans like mortgages unprofitable. (Short-term interest rates for banks to borrow money were higher than the interest rates they could charge for mortgages. For a thrift to make a 30-year mortgage, he would have to lend the money at 10

[55] Lewis, p. 83

[56] Lewis, p. 100

percent, but had to borrow at 12 percent.) If thrifts wanted to restart their anemic mortgage business, they would have to find new sources of capital that did not include short-term loans. Securitization of their existing loan portfolios, it turned out, was the answer.

Salomon Brothers issued the first mortgage-backed securities in 1977, but it was not until 1981 that the market took off, thanks to a tax break designed to alleviate the teetering mortgage business of the savings and loans. The tax break, passed by Congress in 1981 after much lobbying, was designed to encourage thrifts to sell their mortgages to put the proceeds of the sale towards higher returns. While the stated purpose of the legislation was to lessen thrifts' reliance on the sickly mortgage market, its phenomenal benefit to the thrift industry was that any losses taken on the loan could be offset against taxes the thrifts had paid over the last ten years. This gift by Congress to the thrift industry gave the thrifts every incentive to unload their mortgage portfolios without regard to loss. And so thrifts began selling their mortgages to Wall Street at huge losses—65 cents to the dollar was not unheard of.[57] Whatever the loss, the thrifts didn't feel any pain—a check from the IRS would make up the difference, giving the thrifts an easy way to cash out their unremarkable long-term mortgages and put the money to work, taking advantage of the record-high short-term interest rates. The Wall Street investment banks in the meantime made billions of dollars of profits. By buying mortgages at 65 cents on the dollar, they could easily securitize them and sell them at 85 to 90 cents on the dollar—promising the investor who bought the mortgage-backed security a handsome profit as well. The birth of the mortgage-backed security took place among what one

[57] Lewis, p. 104

investment banker in the mortgage-backed securities market then termed "the most irresponsible period in the history of the capital markets."[58]

The savings and loan tax break of 1981 may have opened the flood gates on the mortgage-backed security market, but the trend was not a gimmick: securitization—and securitization of mortgages—plays a vital role in keeping markets capitalized, and ensuring that capital is available to those who need it. One role that early mortgage-backed securities played was making capital available for mortgages in fast-growing parts of the country. In the late 1970s and early 1980s, the Sun Belt states of Arizona, Nevada, Texas, and Florida saw rapid growth as industrial cities in the Rust Belt saw significant population declines. These trends created a natural boom the the Sun Belt housing market, but because Sun Belt thrifts were much smaller than savings and loans in other parts of the country, they did not have ready sources of capital to finance the mortgages that would fuel the housing boom. With mortgages in that era still being written by community banks (it would not be until the 1990s that national banking operations would become significant players in the mortgage industry), thrifts sought capital from other sources. The mortgage-backed security offered a ready-made solution: banks in the capital-rich but depopulating Rust Belt would effectively finance the mortgages written by capital-poor but rapidly growing Sun Belt. Both the bank in Phoenix and the bank in Cleveland would profit from the boom in Arizona housing, with a Wall Street investment banker also taking a nice cut. The homeowner in Phoenix would make his payment to his local thrift who would then pass the money along to the investment bank, which issued the mortgage-backed security. The Cleveland bank which owned the mortgage-backed security would receive the

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[58] Lewis, p. 155

mortgage payment (along with thousands of other mortgage payments bundled into the mortgage-backed security) for the life of the mortgage-backed security.

NO SECURITY

The mortgage-backed security changed the face of investment and retail banking in the 1980s and the decades to come. The mortgage-backed security's unquestionable success in the early 1980s spurred two developments that would define the finance industry—and consumer finance—for the next two decades: it led to the securitization of nearly every type of loan; and, because Wall Street dominated the securities trade, it undermined the power of local thrifts, leading to a massive wave of consolidation that would define the banking industry in the late 1980s and 1990s. It was these two events—directly attributable to the success of the mortgage-backed security— that would erode the caution that banks, even in the go-go 1980s, exercised when loaning money. It was this phenomenon that would put into motion a chain of events that would eventually lead to the mortgage-backed security's undoing.

The mortgage-backed securities of the 1980s were solid investments because the essential bet that the investor was making—that the borrower will pay back his loan—was a good one. Thrifts vetted potential borrowers, significant down payments were required, and exotic payment options catering to the lowest-common denominator did not exist. The mortgage-backed security was only as good as the mortgages it represented, and in the 1980s mortgage marketplace, local thrifts generally did a good job of ensuring that its loans were sound. A generation ago, retail banking was a local affair. Americans had bank accounts at and took out mortgages from small- and medium-sized banks in

their communities. In 1980, there were 2,004 savings and loans across the country. By 2007, there were 1,244[59] and today, consumer banking is dominated by a handful of national banking chains—Bank of America, J.P. Chase, Citibank, Wells Fargo, and other names as familiar to those in Dallas as they are to those in Boston.

In the 1980s heyday of the mortgage-backed security, the balance of power in the finance industry shifted so far in favor of the Wall Street bankers issuing mortgage-backed securities that it undermined the thrifts' key role in the financial system. This was done through the sheer market power that the investment banks exercised, but also because local thrifts were woefully outgunned by Wall Street. Local thrifts were typically controlled by local community leaders; MBAs and finance-degree holders were few and far between in ranks of the leadership of thrifts in the 1980s. This lack of sophistication allowed Wall Street investment bankers to orchestrate extremely complex securities deals with the capital of the thrifts, with the thrifts' leaders often not fully understanding what was happening. This lopsided balance of power did not escape those on Wall Street. At Salomon Brothers, Lewis writes, the investment bankers viewed their savings and loan clients as "mere sheep rancher[s] next to the hostshot cowboys on Wall St."[60]

Retail banks sought to strengthen their hand by thinning out the ranks of the weak. The result: a decade of mergers. Take the typical example of First Pennsylvania Bank, a medium-sized retail bank that was one of Pennsylvania's biggest in the late 1980s. In 1991, First Pennsylvania was bought by CoreStates Bank, which was then bought in 1998 by First Union, which in 2001 merged

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[59] Data on the number of thrift operations from the Insurance Information Institute Financial Services Fact Book. Accessible online at http://www.iii.org/financial2/banking/thriftinstitutions/

[60] Lewis, p. 84

with Wachovia, which in 2008 was bought by Wells Fargo. The wave of mergers that kicked off in the early 1990s stood in marked contrast to the rash of financial mergers a decade earlier, when many bank regulations were first relaxed. In the early 1980s, banks were buying investment companies: in 1981, American Express bought the brokerage firm Shearson Loeb Rhodes; later that year Prudential Insurance acquired Bache Securities; in 1982, BankAmerica Corporation merged with Charles Schwab & Company.[61]

The new behemoth banks of the 1990s were the precise opposite of the small-town savings and loans that they supplanted: they were large corporations bent on turning quarterly profits and pushing their share prices higher—and were run as such. The personal touch that is said to disappear when a local operation gets gobbled up by a national chain is often lamented. In the case of the big banks, it was their Achilles' heel. The prudence with which loans were given—particularly mortgages—went out the window. While just a few years before, an application for a mortgage would have required a series of meetings with a local banker who would interview the banker and then consider whether the loan were worth putting his bank's money and his personal reputation on the line; now, at the large corporate bank, a mortgage applicant would likely be directed to a toll-free hotline, or at best, meet a low-level employee who keys his application into a computer and waits drone-like for the computer to tell him what to do. Consider the example of the Washington Mutual mortgage processing center in the previous chapter. The mortgage officers were not working in banks, they were working in a glorified call center. And they were not making decisions—the computer was making the decisions for them. If an application came in with obviously dubious information—baby sitters "claiming salaries worthy of college presidents and

[61] Manning, p. 80

schoolteachers with incomes rivaling stockbrokers'," according to one mortgage officer's account in the *New York Times*— workers rarely questioned the information.[62] For one thing, it would be harder to ask questions from a remote call center than sitting across the table from an applicant in a meeting. (It would also take considerably more gall for a 20-year-old baby sitter to claim a six-figure salary when sitting at a mahogany desk across from a banker.) But the question also wouldn't be asked because it would cut into the bank's short-term profit. Retail banks made billions of dollars in fees from writing mortgages in the 1990s and 2000s. And the ever-increasing securitization of mortgages meant that the banks got paid regardless of whether the loan performed: as soon as the loan was sold and securitized, the banks had their money, and the loan was no longer their problem.

So obvious were the big banks' emulation of corporate America that then-Washington Mutual CEO Kerry K. Killinger said in 2003: "We hope to do to this industry what Wal-Mart did to theirs, Starbucks did to theirs, Costco did to theirs and Lowe's-Home Depot did to their industry. And I think if we've done our job, five years from now you're not going to call us a bank."[63] The macabre truth: by 2008 Washington Mutual, for all intensive purposes, was not a bank. It was rendered insolvent by its reckless sub-prime lending, forced into FDIC receivership, and its remnants sold off to J.P. Morgan Chase.

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[62] As reported and quoted in the *New York Times* article "Saying Yes, WaMu Built Empire on Shaky Loans," December 27, 2008. Accessible online at http://www.nytimes.com/2008/12/28/business/28wamu.html?pagewanted=all

[63] *Ibid.*

FREE FOR ALL

In the late 1990s and 2000s, banks doled out credit cards and mortgages to anyone who wanted one. Demonstrating that mortgage and credit card lending are two very similar sicknesses, banks and Wall Street moved to securitize credit card loans beginning in the 1990s just as mortgages were a decade earlier. Today, more than half of all consumer loans, including credit card loans, are securitized.[64] Securitization of credit card debt gave banks the same incentive to lend recklessly to credit card lenders as it did to mortgage lenders: if the debt isn't repaid, the security-holder is left holding the bag, not the bank.

In the days before widespread securitization, being repaid by borrowers was of paramount importance to banks. But as credit card debt was securitized, banks changed their business model: for the last decade, repayment of the debt is secondary to the fees and charges that the bank can generate from the credit card. "Today the focus for lenders is not so much on consumer loans being repaid, but on the loan as a perpetual earning asset," said Julie L. Williams, chief counsel of the Comptroller of the Currency, in a March 2005.[65] The higher over one's head a borrower gets, the less likely the loan is to be repaid—but the more penalties and fees he racks up. This works to the banks' advantage: the debt is securitized (so it's someone else's problem whether he gets repaid), but the late fees and over-the-limit penalties that accrue every month go straight to the bank.

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[64] As reported in the *Economist* article "Too Big to Swallow," May 14, 2009. Article accessible online at http://www.economist.com/surveys/displaystory.cfm?story_id=13604641

[65] As quoted in the *New York Times* article "Given a Shovel, Americans Dig Deeper Into Debt," July 20, 2008. Article accessible online at http://www.nytimes.com/2008/07/20/business/20debt.html?_r=1&pagewanted=all

By the late 1990s, the trend of securitization and consolidation had already changed the financial landscape. Big banks dominated the retail market, but Wall Street investment banks still held a monopoly an issuing bonds, asset-backed securities, and other high-ticket financial products. For decades, the banking industry had sought the repeal of a 1933 law called the Glass-Steagall Act, which forbade retail banks from operating investment banking divisions. In 1999, the banks finally got their wish when the Gramm-Leach-Bliley Act tore down the wall keeping commercial and investment banks separate. Almost immediately, a spate of mergers followed: Citigroup was formed out of the commercial bank Citibank and the financial services group Travelers Insurance (which included the investment bank Smith Barney, which a year earlier had bought Salomon Brothers, the inventor of the mortgage-backed security); Wachovia acquired Prudential Securities and A.G. Edwards, two retail brokerage firms. Commercial banks created investment arms—Bank of America, for example, created Banc of America Securities, branching out into investment banking without a merger or concern for orthography. The trend of commercial banks emulating investment banks would be drastically and dramatically reversed in 2008, when every major investment bank would either collapse or convert to a bank holding company in order to receive government protection and easier access to capital.

5|| The Ownership Society

"We can put light where there's darkness, and hope where there's despondency in this country. And part of it is working together as a nation to encourage folks to own their own home."
— President George W. Bush, October 15, 2002[66]

"How did we get here?"
— Bush, September 18, 2008, to Federal Reserve chairman Ben Bernanke and then-Treasury secretary Henry Paulson, surveying the financial wreckage after credit markets froze[67]

Consumer avarice and untrammeled market capitalism are two icons of Americana that need little encouragement to thrive. But in the case of the housing binge, bubble, and burst, the American government played the role of enthusiastic matchmaker to two already eager-to-couple demographics: banks and consumers. By the time the housing craze hit fever pitch in the mid-2000s, there were few levers that the federal government did not pull in its bid to drive up homeownership rates as high as possible. In October 2004, as the housing market was roaring higher and Bush was riding its tailwind to re-election, he told a campaign crowd, "We're creating. . .an ownership society in this country, where more Americans than ever will be able to open up their door where they live and say, welcome to my house, welcome to my piece of property."[68]

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[66] As delivered by President Bush in a speech promoting his homeownership policies at the George Washington University on October 15, 2002. Transcript available for download in PDF format from the Government Printing Office at http://ftp.resource.org/gpo.gov/papers/2002/2002_vol2_1811.pdf (remarks on page 1811)

[67] As reported by the *New York Times* on December 20, 2008 in an article titled "White House Philosophy Stoked Mortgage Bonfire." Article accessible online at http://www.nytimes.com/2008/12/21/business/21admin.html?_r=1&pagewanted=all

[68] As reported and quoted by Naomi Klein in her January 2008 article for *The Nation,* "Disowned by the Ownership Society," accessible online at http://www.thenation.com/doc/20080218/klein.

Homeownership reached a high of 69.1 percent in 2005.[69] Minority homeownership—a keystone of Bush's compassionate conservatism and a constant theme in his 2004 re-election campaign—peaked at nearly 60 percent the same year.[70] The goals of Bush's ownership society, on a human level, were noble. On a financial, economic, and practical level, they proved to be calamitous. In the first quarter of 2009, one in eight homeowners was either late on a mortgage payment or in the process of foreclosure.[71] Fannie and Freddie, the two government-sponsored enterprises that enabled much of Bush's ownership society, lost hundreds of billions of dollars in 2008 and now sit in government conservatorship. Most importantly, the homeownership rate is now 67.3 percent—below the level when Bush took office in 2001[72]—a harsh verdict on the ownership society, whose financial misadventures will cost taxpayers well over $1 trillion in bailouts and stimulus spending as the government seeks to repair its catastrophic failings.

FANNIE AND FREDDIE

The federal government has many tools at its use to lubricate the housing market, ranging from the inadvertent (such as the previously discussed 1981 tax break for thrifts that fueled their rush into mortgage-backed securities, forever redefining the housing market), to the explicit (case in point: its

[69] "Homeownership Rates for the U.S. and Regions" (historical data). U.S. Census Bureau. Data table available for download in .xls format at http://www.census.gov/hhes/www/housing/hvs/historic/index.html (Table 14)

[70] Based on homeownership data from the U.S. Census Bureau's 2005 annual statistics and a 2009 Pew Hispanic Center's survey on immigrant and minority homeownership. Both are accessible online. U.S. Census Bureau data: http://www.census.gov/hhes/www/housing/hvs/annual05/ann05t20.html. Pew Hispanic Center survey: http://pewresearch.org/pubs/1220/home-ownership-trends-blacks-hispanics

[71] According to the Mortgage Bankers Association, as reported by Bloomberg on May 28, 2009. Article accessible online at http://www.bloomberg.com/apps/news?pid=20601087&sid=a2zH6o6F7Wuc&refer=home

[72] "Housing Vacancies and Homeownership, First Quarter 2009." U.S. Census Bureau. Information accessible online at http://www.census.gov/hhes/www/housing/hvs/qtr109/q109ind.html (refer to press release and Table 5.)

political leverage over Fannie and Freddie), to the apolitical but nevertheless critical role played by the Federal Reserve. Whatever role the government takes in the housing market, one principle has remained constant: when the government concocts programs and legislation to game the market, the market will always get vengeance. Nothing proves this better (or more expensively) than the cases of Fannie Mae and Freddie Mac, the two government-sponsored entities at the root of the explosion in the mortgage market and the government's multi-decade campaign to keep the market juiced.

The federal government had been a crucial figure in mortgage lending since the New Deal. Until 1968, its role had been overwhelmingly as a regulator to guard against Depression-like housing catastrophes. But 1968 marked a watershed, when the Congress privatized what was then best known as the Federal Home Mortgage Association—then the sole government agency responsible for financing mortgages. The newly privatized corporation retained its formal name but gained the playful moniker Fannie Mae and a revitalized mission. Under the nebulous classification as a government-sponsored enterprise, its mission was to buy mortgages with cheaply borrowed money from the government, and use that money to juice the mortgage market and expand homeownership. In 1970, Congress chartered Freddie Mac as a GSE with a nearly identical mission. Being a government-sponsored entity meant existing in a sui generis hybrid world: Fannie and Freddie were private for-profit corporations, but created with an explicit political goal and given access to capital at rates available only to government borrowers. In other words, private profits and public risk in the pursuit of a political goal—the expansion of homeownership.

Fannie and Freddie were two strange creatures straddling the territory between Washington, Wall Street, and Main Street. To be sure, they bore the mark of Washington: The president appointed

nearly a third of the organizations' boards of directors and both companies were exempted from state and local taxes. But what made Fannie and Freddie so appealing to investors—and so unparalleled in the world of finance—was what was called the "implicit guarantee"—that the federal government would act as a backstop in case either organization ran into financial problems. (As the financial crisis unfolded, the implicit guarantee was made explicit in September 2008 when the two organizations were taken over by the federal government.) Fannie and Freddie may have been confusing organizations with ill-defined loyalties, but in their first decade they were primarily two things: profitable and successful. The homeownership rate increased from 63.6 percent in 1968 to 65.8 percent in 1979. And the profits that the pair of GSEs racked up were so lucrative that Wall Street began to get in on the act in the early 1980s, creating competition on the secondary market. (Wall Street investment banks both competed with Fannie and Freddie, buying mortgages directly from banks, and also acted as a buyer to Fannie and Freddie, buying already-once-sold loans from the GSEs. These mortgages were almost invariably resold as mortgage-backed securities as described in the previous chapter.)

With Wall Street now flooding the mortgage market with billions of dollars of capital, questions of competition and fairness were raised: Fannie and Freddie had access to capital at rates available to only government borrowers, making their cost of lending lower than any Wall Street competitors. The result was a de facto duopoly—or GSE monopoly—over large sectors of the secondary mortgage market—particularly in low- and middle-income housing. The two companies' access to dirt-cheap capital and implicit government backing (which obviated risk) ensured that Fannie and Freddie would dominate whatever parts of the mortgage markets they entered. But nothing that good comes free. With Congress giving Fannie and Freddie a sweet deal of cheap cash and a

government guarantee, Congress naturally wanted something in return: political favors. Of course, this was the arrangement from the beginning: Fannie and Freddie were chartered with the goal of expanding homeownership to all Americans. But as the decades went by, the pressure would get more intense, until it crescendoed in the 2000s when George W. Bush and Congress made expanding homeownership a priority like never before. Fannie and Freddie were more than willing to play ball. Fannie and Freddie the harnessed the meteoric housing market and led Bush's and Congress' charge to expand homeownership to nearly anyone who wanted a home—and made billions of dollars in the process.

THE BUSH ERA

Faced with a housing market in free fall in July 2008, President Bush offered a simple explanation as if he were a detached observer: "Wall Street got drunk," the recovering alcoholic told a group of Republican fund raisers in Texas. "It got drunk and now it's got a hangover. The question is, how long will it sober up and not try to do [sic] all these fancy financial instruments?"[73]

This was the same president who once proclaimed that he would "use the mighty muscle of the federal government" to expand his ownership society. But in the pre-housing crisis days, expanding homeownership was smart politics for a Republican president bent on expanding his party's reach to the fast-growing Hispanic population and the black electorate, long alienated from the Republican Party. The Republican vision of an ownership society, he surmised, would appeal to

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[73] President Bush made this off-the-cuff remark at a fund raising event for Texas Republican congressional candidate Pete Olson on July 18, 2008. The comments were videotaped on an attendee's cellular telephone and uploaded to the video sharing Web site YouTube. News story from Reuters accessible online at http://uk.reuters.com/article/worldNews/idUKN2330503720080723. Original video viewable on YouTube at http://www.youtube.com/watch?v=z_FDRiluLJQ.

minorities in a simple way that Democratic social spending didn't: they would own the most important part of the American dream—a house. His programs included the American Dream Downpayment [sic] Initiative, which budgeted $200 million for low-income families to put toward down payments on mortgages, (Bush was behind the times; many mortgages to low-income homebuyers were of the no-down-payment variety), expanded tax credits for low-income homebuyers, and something called the Self-Help Homeownership Opportunities Program (the name itself says enough about the soundness of the loans it encouraged). And whom did Bush and many in Congress—both Democrat and Republican—lean on? On Fannie Mae and Freddie Mac—the president's mighty muscle. The president appoints nearly a third of each company's board of directors.

But Fannie and Freddie did not go kicking and screaming into the arrangement—it was just the opposite. Fresh off of separate accounting scandals related to executive bonuses and compensation in 2003 and 2004 (which were unrelated to its later woes), Congress was debating tighter regulations on Fannie and Freddie. In hearings, economists from the Federal Reserve and Congressional Budget Office testified that despite the two companies' government-subsidized borrowing rates, they did not significantly reduce the cost of mortgage borrowing to consumers.[74] Then-chairman of the Federal Reserve Alan Greenspan became a vocal critic of Freddie and Fannie and publicly called for them to be reined in, increasing pressure on Congress to do so. With government economists testifying that they weren't making mortgages cheaper, and their executives embroiled in multi-billion-dollar accounting scandals, Fannie and Freddie needed to make a politically palatable case for their *raison d'être*. They found it in affordable housing—Bush's pet

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[74] As reported in the *Wall Street Journal* on September 23, 2008 in a feature titled "Blame Fannie Mae and Congress for the Credit Mess." Article accessible online at http://online.wsj.com/article/SB122212948811465427.html

political cause. Bush and Congress had the goal of expanding homeownership to the low income-earners. Fannie and Freddie wanted to escape regulation. Naturally, a compromise was found. "Fannie Mae and Freddie Mac have played a very useful role in helping to make housing more affordable . . . 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," Rep. Barney Frank (D–Mass.), the now-chair of the House Financial Services Committee said at a 2003 committee hearing on GSE reform.[75]

But this arrangement didn't mean that Fannie and Freddie bought into a bad deal as part of political penance. Fannie and Freddie made enormous profits during the housing boom on the same dubious mortgages that banks sold and Wall Street traders bought. If anything, due to their domination of the secondary mortgage market, Fannie and Freddie opened the floodgates for bad mortgages to be made to unqualified borrowers—the happy denizens of the ownership society. The degree to which Fannie and Freddie dominated the secondary mortgage market cannot be understated; because capital markets treated Fannie and Freddie as government-backed buyers, they had an unlimited borrowing capacity. With a customer whose pockets were infinitely deep, the mortgage market produced the kinds of loans that Fannie and Freddie wanted. And beginning in 2004, those loans were sub-prime and Alt-A loans. Sub-prime and Alt-A mortgages rose from less than eight percent of all mortgages in 2003 to more than 20 percent in 2006. During the same period, the quality of the subprime loans became increasingly low. Whereas in 2003, long-term fixed rate loans were the norm, by 2006, loans with low down payments and low adjustable initial rates became standard,

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[75] *Ibid.*

indicating, that as a 2008 *Wall Street Journal* analysis put it, "originators were scraping the bottom of the barrel to find product for buyers like the GSEs."[76]

Reflections on the ownership society from the Bush White House in post-meltdown 2008 were astonishing in their admission of naiveté, incompetence, and disregard of economic realities. Several alumni of the Bush White House were interviewed by the *New York Times* in December 2008:

> Said John Snow, Bush's treasury secretary from 2003-2006:
> *"The Bush administration took a lot of pride that homeownership had reached historic highs. But what we forgot in the process was that it has to be done in the context of people being able to afford their house. We now realize there was a high cost."*[77]
>
> Tony Fratto, Bush's deputy press secretary, recalled the former president saying:
> *"We absolutely wanted to increase homeownership, but we never wanted lenders to make bad decisions."*[78]
>
> Lawrence Lindsey, Bush's chief economic adviser during his first term, at least admitted the political reality:
> *"No one wanted to stop that bubble. It would have conflicted with the president's own policies."*[79]

THE FED AND MONETARY POLICY

There has been no shortage of public opprobrium heaped on the lawmakers and politicians on whose watch the housing market inflated and then spectacularly went bust. But the executive and legislative branches are hardly the only parts of the government to have had a hand in the mortgage

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[76] *Ibid.*

[77] As quoted in the *New York Times* on December 20, 2008 in an article titled "White House Philosophy Stoked Mortgage Bonfire." Article accessible online at http://www.nytimes.com/2008/12/21/business/21admin.html?_r=1&pagewanted=all

[78] *Ibid.*

[79] *Ibid.*

madness. The post-millennial monetary policy of the Federal Reserve Bank fueled the housing market, making housing a more attractive investment than it historically had been. The 1980s and 1990s were decades of high and moderate interest rates. The 2000s, by contrast, were marked by record low interest rates. The effect was to make housing a comparatively more profitable investment than it had been in decades past. In the 1980s, the annual Fed rate (the Federal Funds Rate, which is the benchmark U.S. interest rate) was 9.96 percent.[80] In the 1990s, it was 5.15 percent and in the pre-crisis 2000s, it was 3.43 percent.[81] The historically low interest rates—which were under two percent in 2002, 2003 and 2004—gave Americans a further incentive to invest in housing: the rates of return on investments directly affected by interest rates would be at historical lows. This meant that housing, even if it appreciated at historically normal levels, would deliver higher returns than many alternative investments traditionally would have. And because interest rates were low, it also meant that mortgage rates were cheap—an attractive inducement to anyone on the fence about entering the housing market. When considering investment options, what would be more attractive: interest-driven investments delivering four to six percent annual yields, or property posting double-digit gains every year, financed with dirt cheap mortgages? The math was easy. But as is the case with all too-good-to-be-true government creations, the market would have its revenge.

CREDIT BECOMES KING

By George W. Bush's second term, easy and ubiquitous credit was no longer just a financial tool, it was a way of life. A generation ago, it was common to celebrate when a homeowner paid off his

[80] Calculated from data from the Federal Reserve Board's "Selected Business Rates" publication. Accessible online at http://www.federalreserve.gov/releases/h15/data/Annual/H15_FF_O.txt

[81] *Ibid.*

mortgage in full by burning the mortgage note with family and friends. But that was when the American dream was owning a house, being free of debt, and controlling your destiny. The current version of the American dream promotes just the opposite: buying a house you can't afford on credit, borrowing against a house that already has you drowning in debt to secure more credit, and being forever enthralled to the cult of consumption. Hardly any person in America or part of American society was able to escape reliance on cheap and easy credit: homeowners loaded up on it to buy the biggest house they could; consumers financed their lifestyles on credit cards; banks gave credit to anyone who came asking, pocketing billions of dollars in fees along the way; George W. Bush rode the "ownership society" dream-cum-reality to re-election in 2004; Wall Street grew rich on fat profits from packaging and selling debt. America enjoyed a long and luxurious love affair with credit and consumption for nearly a quarter century. But like any failing romance, the writing had long been on the wall that the relationship was doomed.

6|| Crash

On September 15, 2008, when Lehman Brothers went bankrupt and the American economy began a two-week meltdown unparalleled by anything since the Black Tuesday 1929, Americans were left scratching their heads. Cable news programs began assembling cute animations hoping to make sense of credit-default swaps and collateralized debt obligations to the average American. The financial arrangements, deals, and products that sent the world economy are indeed complicated—complicated enough that it is unreasonable to expect any significant portion of the public to

understand them. The Lehman bankruptcy was the event that turned what was then the relatively benign credit crunch into the economy-killing financial crisis. Someone speaking the lingo of Wall Street would explain the situation as Lehman's failure to unload large collateralized debt obligations with the lowest-rated mortgage tranches. To the average American, this is indecipherable—and it doesn't sound like anything he could possibly be responsible for. And because this technospeak sounds like a foreign language, the average American assumes that it has nothing to do with him. But the financial meltdown has everything to do with him—it started precisely with the average American.

The house of cards that brought Lehman down started to be built when Americans began lusting after houses that were beyond their means. That lust, thanks to an eager-to-please real estate agent and a mortgage officer who just couldn't say no, was sated with a huge mortgage—one that could never be repaid relying solely on the borrower's means. But he wasn't to worry. He made no down payment and only had to make the interest payments for five years. The real estate agent and the mortgage officer then happily pocketed their commissions, and the thousands of dollars in mortgage fees the bank took gave a nice boost to its quarterly earnings figures. The bank then quickly sold the mortgage on the secondary market where it was bundled into a mortgage-backed security along with thousands of other dubious mortgages made to unqualified buyers. Those mortgage-backed securities were then sold on to other investment banks who packaged them as one of the lower-class tranches of a collateralized debt-obligation. It was a long way from point A—Joe Q. Public's lust for the house with the white picket fence—to point Z—Lehman Brothers being sacked with toxic assets—but the principle is easy to understand: the simple crassness of American consumerism

created the labyrinthine financial mess that has crippled credit markets, brought the financial system to its knees, and thrust the world economy into its deepest recession in a half century.

Every red-letter event that has made up the financial history of the crisis has an explicit analogue in the world of unrestrained American consumerism. How to explain the failure of AIG, which imploded when credit-default swaps it underwrote weren't able to cover losses in CDOs? Look to the American lust for unaffordable houses. The two-rounds-and-counting of government bailouts for General Motors and Chrysler? A good deal of blame can be placed on the industry's laziness and reliance on one product line, SUVs, to provide its profit without taking into account the fickle public. These are, of course, oversimplifications, but they express the root of the problems: If only people who could afford houses bought houses, the toxic mortgages that brought down Wall Street would not be toxic—they would be profitable. And if General Motors designed products that were practical and did not just cater to the consumerist fad of the moment, when the winds of desire shifted, it would still have a product that people wished to buy.

CONCLUSION || No Reckoning

With the calamitous consequences of Americans' rapacious use of credit to finance an extravagant and fantastic lifestyle laid bare before them—unemployment nearing 10 percent, the Dow Jones more than 50 percent off its historic highs, new social service cuts being announced every week—have Americans learned their lesson? Are they ready to re-evaluate their behavior? All signs point to no. Two and a half weeks after the financial crisis raged into full panic mode, vice presidential

candidate Sarah Palin—the so-called "everywoman" politician—offered her analysis of the financial crisis:

> *[T]here have been so many changes in the conditions of our economy in just even these past weeks that there has [sic] been more and more revelation [sic] made aware [sic] now to Americans about the corruption and the greed on Wall Street. We need to look back, even two years ago [sic], and we need to be appreciative of John McCain's call for reform with Fannie Mae, with Freddie Mac, with the mortgage-lenders, too, who were starting to really kind of rear that head of abuse. . . .It is a crisis. It's a toxic mess, really, on Main Street that's affect[ed by] Wall Street. And now we have to be ever vigilant and also making sure [sic] that credit markets don't seize up. That's where the Main Streeters like me, that's where we would really feel the effects.*[82]

Though the Alaska governor mangled her words a bit, her sentiment was clear: Wall Street's greed corrupted the frugal, hard-working folks on Main Street. The idea is ridiculous: the greed and toxicity started on Main Street and then spread to Wall Street. In order for the Wall Street bankers to be able to afford their Park Avenue condominiums, they needed a lot of Gov. Palin's so-called Main Streeters to lust after houses with white picket fences and three-car garages. Or as political commentator George Will said two days before Palin's remarks:

> *Populism flatters the people, contrasting their virtue with the alleged vices of some minority—in other times, Jews or railroad owners or hard money advocates; today, the villain is "Wall Street greed," which is contrasted with the supposed sobriety of "Main Street." When people on Main Street misbehave by, say, buying houses for more than they can afford to pay, they blame the wily knaves who made them do it.*[83]

There are signs that Americans are reacting to the recession by embracing frugality: the personal saving rate, 4.2 percent, is a ten-year high[84]; the average size of new houses fell in 2008 for the first time in nearly 15 years[85]; and media accounts report that Americans are eschewing the once high-

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[82] Transcript of the 2008 Vice Presidential Debate held October 2, 2008. Accessible online at http://elections.nytimes.com/2008/president/debates/transcripts/vice-presidential-debate.html

[83] "A Vote Against Rashness" by George Will. October 1, 2008. Syndicated by the Washington Post Writers Group. Accessible online at http://www.realclearpolitics.com/articles/2008/10/publics_fury_noted_now_is_time.html

[84] U.S. Department of Commerce, Bureau of Economic Analysis, "Personal Saving Rate," April 29, 2009. Accessible online at http://www.bea.gov/briefrm/saving.htm

[85] According to data from the U.S. Census Bureau's "Characteristics of New Housing Index." Accessible online at http://www.census.gov/const/www/charindex.html

flying faux-luxury brands and retailers in favor of cheaper options. But the question remains: Is this shift to frugality a temporary reaction to tight times, or a reevaluation of a 25-year rampage of consumerist excess? There is no evidence to point to any change in mindset. Americans still hold more than $2.5 trillion worth of consumer debt that is collecting interest every month—something that choosing Shasta over Coke won't easily erase. Turning the page on America's culture of excess will require something more than the piecemeal chipping away of an unfathomably large debt: it will require responsibility and restraint. With the large majority of the country pointing their fingers of blame at Wall Street and Washington—but most certainly not at themselves—it seems certain that that day of reckoning is as far off today as it ever has been.

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DECLARATION

I hereby declare that this thesis is my own work, based on the sources and literature listed in the appended bibliography. The thesis as submitted is 130,249 keystrokes long (including spaces), i.e. 73 manuscript pages.

Andrew Metzger
11 June 2009
Prague