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Not just a mortgage crisis: How finance maimed society

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The mortgage crisis of 2008 quickly morphed into an economic crisis

- Through re-financing and lines of credit enabled by mortgage securitization, house price increases fueled economic growth and disguised weakness in the real economy
  - One-quarter of new jobs created between 2003-2006 were in housing-related industries (real estate, mortgage brokerage, home improvement)
  - Roughly $300B/year went for personal consumption, promoting growth in retail employment
- When real estate prices reversed, the rest of the economy followed suit

The mortgage bubble was part of a broader shift toward a finance-centered economy

- **Changes in the finance industry**
  - **Securitization**
  - **Consolidation**
  - **Dis-aggregation**
- **Changes in households**
  - **Ties to finance**
  - **Economic worldviews**

The basic business of banking has changed

"No, but you . . . you . . . you're thinking of this place all wrong. As if I had the money back in a safe. The money's not here. Your money's in Joe's house . . . right next to yours. And in the Kennedy house, and Mrs. Macklin's house, and a hundred others. Why, you're lending them the money to build, and then, they're going to pay it back to you as best they can. Now what are you going to do? Foreclose on them?"

Banking 2.0: This time, it's impersonal

"No, but you . . . you . . . you're thinking of this place all wrong. As if I held your mortgage on my balance sheet. I sold your mortgage to Countrywide 10 minutes after we closed the deal, and they sold it along with 3000 other mortgages to Merrill Lynch, which divided it into bonds that were bought by a Cayman Islands LLC, which bundled them together with other mortgage-backed bonds into a collateralized debt obligation that Citigroup sold to a Norwegian pension fund. Now what are you going to do? Stop making your payments and force those Norwegian retirees to go back to work?"

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Securitization: or, What can be bundled together and sold as bonds?

- Mortgages
- Auto loans
- Student loans
- Corporate loans
- Credit card receivables
- Business receivables (even in distress)
- Settlements of tobacco lawsuits
- David Bowie's royalties
- Blends of the above (CDOs)
- Your neighbors' life insurance policies

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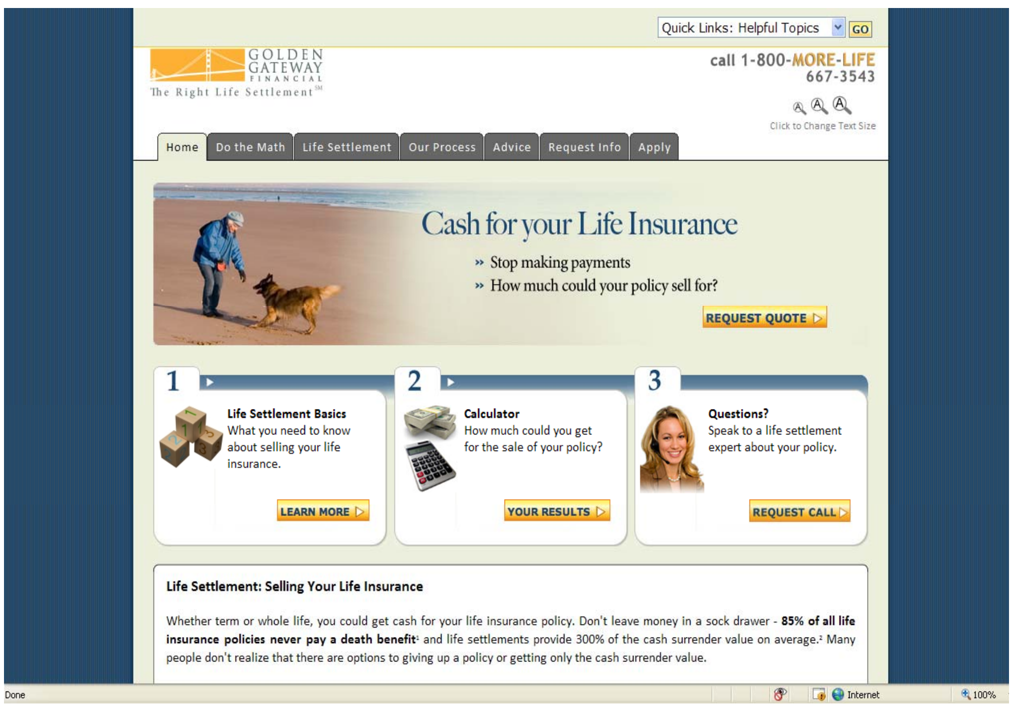

Is securitization addictive for investment banks?

- High fixed costs and strong demand from investors gave investment banks strong incentives to maintain the flow of securitization transactions
- "Once you get into it, it's a bit like heroin" (Economist James Mason)

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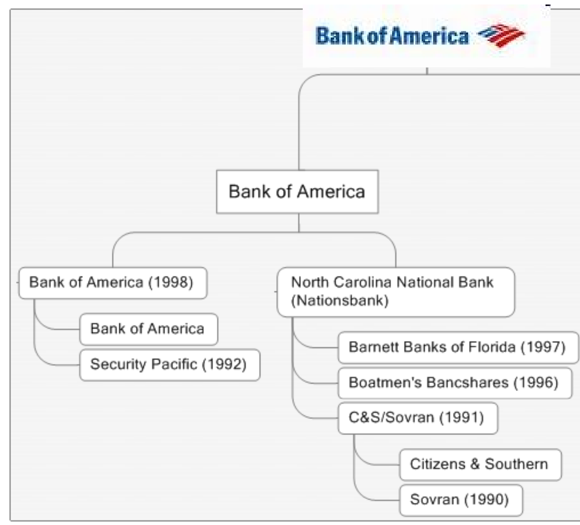
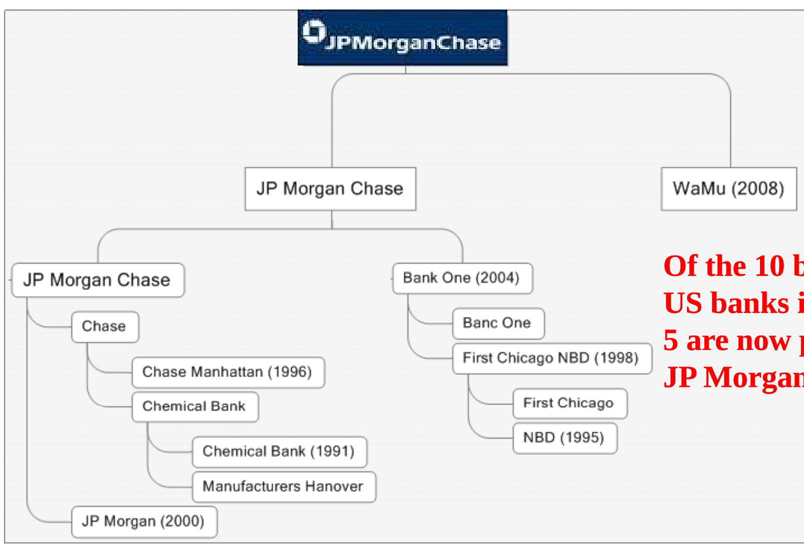
Thanks to securitization, a US bank today is often a façade—a portal to financial markets

How North Carolina National Bank became Bank of America



Bank of America holds nearly 10% of all deposits in the US through its 5800 branches

How (almost) every New York-based commercial bank became JP Morgan Chase



Of the 10 biggest US banks in 1989, 5 are now part of JP Morgan Chase

Securitization has thoroughly transformed banking

- Industry boundaries are dissolved (e.g., commercial vs. investment banking)
- “Local” banking is largely an anachronism
- Financial institutions are both larger and more disaggregated
- The regulatory system was completely mis-matched to the industry, encouraging legerdemain among both participants and regulators

How households turned into banks

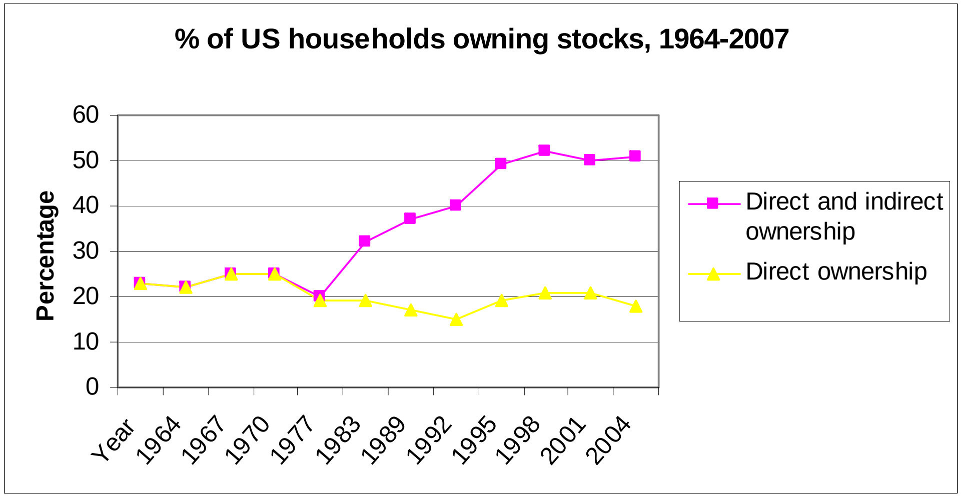
- Lower transaction costs for participating in financial markets encouraged households to become both “investors” and “issuers”
- Investors
  - Increased use of 401(k) plans
  - Increased purchases of retail mutual funds
  - By 2001, most American families were invested in the stock market
- Issuers
  - Securitized home mortgages
  - Auto loans, student loans, credit card debt, insurance settlements…

Economic effects of household participation in financial markets

- **Thanks to mortgage securitization and low interest rates, most homeowners with mortgages refinanced them during the first half of this decade**
- **The personal savings rate (employment income – spending) in the US turned negative in 2005 for the first time since the Great Depression**
- **But don’t worry:**

“The decline in an often-cited aggregate personal saving rate may not be cause for much alarm for retirement preparedness. Much of this decline can be attributed to spending triggered by wealth increases from capital gains on housing and financial assets.” (*Economic Report of the President 2006*)

As a result, households became increasingly invested in the stock market during the 1980s and 1990s



Source: Federal Reserve *Survey of Consumer Finances* (various years)

Cultural effects of household participation in financial markets

- The optimist’s account: the "democratization of ownership" will turn people into sophisticated, economically literate, Ayn Rand fans who knew what LIBOR is and what the Fed does
- The pessimist’s account: finance will turn people into “Trump Junior” who view everything through the prism of investment
- And the winner is…the pessimists
  - Over ¼ of houses sold in 2005 were purchased as “investments”
  - “There’s been a change in social attitudes toward default...We’re seeing people who are current on their credit cards but are defaulting on their mortgages.” They are “homeowners in name only. Because these people never put up much of their own money, they don’t act like owners.” (Ken Lewis, Bank of America CEO)

Conclusion

- Home ownership has been seen as a source of social stability for generations
- Securitization helped turn homes into stock options, with deleterious effects for neighborhoods and the broader culture