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LESSONS FROM THE FINANCIAL CRISIS

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Steven Sondheim once wrote a musical called *Merrily We Roll Along*, which starts at the end and goes to the beginning. I am going to start my talk today by borrowing that technique. I am going to start this lecture where most lectures of this sort end, by asking the question: can it happen again? Will we have another financial crisis?

Yes, we will. I can guarantee it. When President Obama and Barney Frank and Chris Dodd and Tim Geithner get up before you and say *we will put rules in place that will make sure that a crisis like this will never happen again*, you are hereby duly authorized to roll your eyes.

Why will we have another crisis? The answer has nothing to do with derivatives. It has nothing to do with home mortgages. It has everything to do with the human condition. We are psychologically incapable of preventing occasional financial crises. They say that Wall Street alternates between greed and fear—and that is true so far as it goes. But the truth is *society* fluctuates between fear and greed.

Our grandparents lived through the depression. Their entire lives were built around the memory of having endured that experience. Most of us do not remember that experience firsthand. So that memory fades, and as that memory fades, we forget what can happen. We look back from our position here in the "sophisticated" twenty-first century to the previous crisis—we think back to Dutch tulips, for instance, and we think: *what were they thinking?* That was madness.

Then you think about the South Sea Bubble. The South Sea Bubble was all about a corporation taking on the sovereign debt and getting in return a monopoly on trade. Anybody who studied this would think: *how can that possibly*

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happen? We couldn't do anything like that today. But that is exactly what we have done.

You can talk about derivatives. You can talk about complicated financial vehicles as the root of this. But in truth, the financial crisis of 2008 was simply a period of madness that we went through as a society, and a lot of what I am going to talk about will be breaking down how every piece of financial society, from Wall Street to Main Street, lost its mind.

Jim Grant is one of my favorite Wall Street seers. He is a congenital bear, a Wall Street sage, who thinks hard about things. I called him once in the middle of the crisis, and I said, "Why is it we keep doing this over and over and over? Why can't we learn from this experience?" He said, "It's like sex." And I said, "Well, what do you mean?" He said:

> Compare finance to science. Science builds on a foundation, so whenever there is a new scientific discovery, it is added to the foundation. Inventions or discoveries that took place in 1920 or 1900 or 1870 are still part of the building blocks upon which you learned your own science.
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> Sex isn't like that. You have to make all your own mistakes. People can tell you a hundred times don't do this or don't do that, but you don't listen. You have to make your own mistakes. There are no building blocks. You have to figure it out for yourself. Finance is like that. Finance is so much about psychology. It's about memory. It's about an emotional component that you don't even think is emotional until it's too late. And so your mother can tell you that you should save instead of spend, but you don't really listen, or that you shouldn't get into too much debt or that you shouldn't buy a stock that you don't understand. It doesn't matter. You have to learn it for yourself.

So here we are, eighty-plus years from the Great Depression, and we are learning for ourselves what happens when you do foolish things, when you take on too much debt, when you don't regulate appropriately, when you do all the things that they learned in the 1930s and which we forgot in the 1990s and 2000s. So lesson number one: you have to learn it for yourself.

Lesson number two: this crisis really was not that hard to see coming. This also speaks to how much of this was madness, because you had to lose your mind to get caught up in what was going on both on Main Street, with housing, and on Wall Street, with derivatives.

By the way, the connection between the madness that was going on in 1929 and the madness that is going on now is really quite powerful. If you think about the crash of 1929, when you read about it now, you say, *well of course there was going to be a crash.* It made no sense. Stocks were unmoored from reality; everything was over-leveraged. People were margined to the hilt, and don't forget, there were no margin requirements. You could borrow 100% of the price of stock.

Of course that stock was inevitably going to lead to disaster. And while some people saw it, most people didn't. They were too caught up in the madness.

Not long ago, I came across a presentation given by a man named Lew Ranieri. Ranieri is most famous as one of the creators and popularizers of the mortgage-backed security. The creation of mortgage-backed securities was really the beginning of the financial innovation that eventually overwhelmed regulators and did, in some way, lead to the financial crisis.

A mortgage-backed security is not a bad thing. It allowed Wall Street to buy up mortgages, bundle them into pieces according to risk, and sell them off to Wall Street. At a time when the primary institutions in this country for generating mortgages—the thrift industry—were in terrible straits, mortgage-backed securities created the capital that allowed people to buy homes.

Over time, securitization became widespread and involved not just mortgages, but virtually every kind of consumer debt. But over time, mortgage-backed securities became corrupted, as mortgage originators began selling loans to Wall Street that the borrowers were never going to be able to pay back. These were subprime mortgages. It turns out that this was one of the unintended consequences of mortgage-backed securities: because the originators were selling the loans to Wall Street, they stopped caring whether people could pay the money back. It was, indeed, madness.

It gets worse. Along came yet another financial innovation, called the collateralized debt obligation. This vehicle bundled not the mortgages themselves, but credit default swaps that, in effect, made bets on those mortgages. Mortgage-backed securities were limited to the number of mortgages originators made. CDOs were infinite. Whatever risks existed in the securities themselves were expanded geometrically in the CDOs. Oh, and then Wall Street learned to bundle CDOs. These were called CDO squares. Unlike mortgage backed securities, they had no social purpose. Their only role was to give Wall Street vehicles to trade and profit from.

These are called toxic securities now, to use the technical term. To quote Jim Grant again—this is one of my favorite lines of his—"this is what Wall Street does, every good idea is driven into the ground like a tomato stick." So you take a good idea and you do it, and you do it, and you do it. Suddenly it's not such a good idea and all hell breaks loose.

Let me return to the presentation that Lew Ranieri made. It is December 2006, which means that the bubble has peaked, but not everybody has figured that out yet. He is speaking on a panel at the Office of Thrift Supervision. And the subject of the panel—the subject of the day—is the housing market. And this is what he says:

> One of the little noticed roles that Fannie and Freddie played in the market was as a sort of gatekeeper. Whether loans were Prime, or Alt-A, or Sub-prime, whether they are conforming or non-conforming—everything was always written on agency-standard documentation. If it wasn't done that way, nobody bought it, and that acted as, in effect, a form of control and gatekeeper on what you could and could not do. That standard has completely gotten pushed aside. The rise of innovative mortgage products, coupled with enthusiastic investor support and consumer demand

> for affordable loans in a period of historically high housing prices, has created an extraordinarily powerful private mortgage-backed security sector. By private mortgage-backed security sector, I'm basically talking about the mortgage-backed security sector that is not relying on underlying agency collateral.
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> This new market is unfettered in its enthusiasm, and unchecked by today's regulatory framework. It's because the Inter-Agency Task Force can't touch it. It draws from the capital market as its source of supply, so these loans are not going to portfolio lenders. Eighty percent of loans today are generally originated by mortgage brokers—it's a very different process than in the old days when most loans were made by a loan officer in a regulated institution who had to live with the result of what he was doing, whereas now, 80 percent of these loans are made by a manufacturer who frequently is not at the end of this process.
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> So the gatekeepers of old, being the Inter-Agency Group in this room, and Fannie and Freddie have, to a degree, moved aside, and we have a quasi-gatekeeper in the rating service, and in the end, the real gatekeeper in this housing explosion and this explosion of affordability products—that's the euphemism—I don't even know if he's in the room. I went through the guest list to see if anybody from the SEC was here and I didn't notice a name. . . . [T]hey weren't on the list. And in the end, that is the regulator of the capital market. That is the one who can touch this stuff and make a difference . . . .
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> In the past, the investors could understand and have faith in the underlying value of mortgage-backed securities. They were comprised . . . of "vanilla products"—and there was no layering . . . .
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> Today the transparency of the past has been obscured by a massive proliferation of new products, and as a consequence it is very difficult for investors—institutional and otherwise—to accurately quantify the value and the risk of the opportunities available to them, to which I would say there is the crisis in a nutshell.[1]

Lew Ranieri isn't actually the only person who figured this out. There is a man named Edward Gramlich, a Fed governor, who was very worried about subprime mortgages, not in terms of what they were doing to Wall Street but in terms of what they were doing to communities with the rise of foreclosures and so on. Every once in a while, he would walk into Alan Greenspan's office and he would say, *Mr. Greenspan, don't you think we ought to take a closer look at the subprime thing?* And Alan Greenspan would say, *Oh, no, everything is great.*

If you go to YouTube, there's a YouTube video called *Peter Schiff Was Right.* And Peter Schiff swears that he did not put this together, but that's a little

1. Transcript of Office of Thrift Supervision National Housing Forum 47–48 (Dec. 11, 2006), *available at* http://files.ots.treas.gov/48982.pdf.

hard to believe when you see it. Peter Schiff was basically saying that this was all going to end badly. He was well-known enough that every once in a while he would get on CNBC or Fox News, and he would say this. The people who were interviewing or debating him would openly roll their eyes, scoff at him, laugh at him, call him names on television. So he has a clip. He has a compilation called *Peter Schiff Was Right* that clips together nine or ten of these in a row, over a span of about a year. And I am sure he enjoys watching it.

John Paulson's hedge fund made three or four billion dollars because he figured out this was a bubble that couldn't last. I mean it was not a secret. And here is another one—AIG stopped writing credit default swaps in 2005 because they figured out that the underlying securities were problematic.

Unfortunately, they decided not to hedge the hundreds of billions of dollars they had already written, and they forgot that if they had a collateral call, meaning that if the value of the securities dropped, they would have to pay out money, which it turns out, they didn't really have, but that's a story for my book.

The way I've been thinking about this—and this is lesson number three—is that at every level of society there was a race to the bottom. So what does a race to the bottom mean? It means a diminution of standards, where things that used to really matter, in the minds of an investor or a homebuyer or a Wall Street mogul, stopped mattering.

The Internet bubble is a really good example of the race to the bottom. Why did people buy Internet stocks? Because they were going up. All the standards, all the things that had mattered—P/E ratios, profitability, business models—just got thrown out the window. There were no standards. It was a race to the bottom.

The housing bubble is a more complicated example of that, but it's along the same lines. To paraphrase Daniel Patrick Moynihan, it's defining financial deviancy downward.

Did you know, for instance, that Countrywide did not begin as a sub-prime broker? It began as a broker of prime mortgages. Why did it become a sub-prime broker? Well, in large part it did so because competitors were making sub-prime loans and it was becoming a very big, very profitable part of the lending business. Countrywide started to worry that if they stayed pristine and stayed in the prime business, they would start to lose market share.

So that's the first example of this sort of degradation of standards. They got into sub-prime. They get into sub-prime, and then it's not that long before they are justifying loans with no down payments, loans with no documentation of income, loans where the borrowers are actively encouraged to lie about their financial condition.

So what does the banking system do? They don't say, *That is terrible what our non-bank competitors are doing.* They say—*If we don't get to do this too, we're going to lose market share. We're going to lose profits. Our shareholders are going to be mad at us.* So then they start doing it too.

So now let's go to Fannie and Freddie, which are the primary securitizer of mortgages in the United States. Half of the mortgages in the United States run through Fannie and Freddie. Fannie and Freddie have always been pretty controversial organizations where people, depending on your political point of view, see them as the devil or as sitting next to the throne of St. Peter. They are either an enabler of housing policy or they are a destructive force.

I happen to think that Fannie and Freddie were driven not by politics but by business. So Fannie and Freddie, as Lew Ranieri said, used to be the gatekeepers. If you didn't abide by their standards, it was very hard to make a loan that they would securitize. At some point, in 2004–2005, they get into sub-prime mortgages. The Republicans now say they did that because they were trying to expand home ownership. And, in fact, homeownership did expand in this era. Historically homeownership in the United States has been about 60%. At the height of the bubble, homeownership was 69%. That actually has a lot to do with why we got into all this trouble. An awful lot of people who couldn't afford homes bought them. But I would argue that Fannie did not do this as part of its "vision" to help more lower-income people own their own homes.

I would argue they did it because they realized if they didn't do it, Chase and Citi and Merrill were going to securitize those loans instead, and they didn't want to lose their power in the marketplace. So that was their race to the bottom.

The rating agencies. In January of 2008, there were *twelve* corporations whose bonds were rated triple A. There were 64,000 structured financial products, such as collateralized debt obligations with Triple-A ratings. That was up from 37,000 in mid-2007. So in other words, half the Triple-A-rated securities came in the first half of 2008. That is truly unbelievable.

Why did this happen? Well, if you track the profits of Moody's per employee, against the Triple-A ratings of structured products, they align almost completely. In other words, if you do a chart and one line is Moody's profits per employee and the other chart is the number of Triple-A-structured products that they rate, they rise in perfect tandem.

So the rating agencies become hooked on profits. Rating agency employees really wanted to someday work for Citibank, on the other side, where all the money is made. So their race to the bottom was becoming completely hooked on the need to rate these products Triple A. It was their bread and butter.

How about homeowners? We spend all our time gnashing our teeth about Wall Street and its sins, but homeowners didn't do such smart things either. Here we have another one of those debates in Washington between the Republicans, who basically say *homeowners did dumb things and we shouldn't be bailing them out*, and the Democrats, who are basically saying, *well, sure, but there was so much predatory lending going on, they were preying on people who were unsophisticated.*

Both of these things are true. There *was* a lot of predatory lending going on. On the other hand, who in his or her right mind buys a home with no money down, knowing that they can't even make the first mortgage payment? And you might think I'm exaggerating, but here is a statistic: by 2006, 40% of all sub-prime mortgages were delinquent within the first sixty days. It's hard to believe. As I said, a race to the bottom.

Wall Street's race to the bottom is the one that we are most familiar with because when the crisis hit, Wall Street becomes the focal point. The government doesn't want it to collapse. So that is where it spent its money and its energy.

Why did Wall Street engage in this race to the bottom? Because interest rates were so low, they were desperate for yields. They needed a spread that was a little bit wider than what they could get through an ordinary bond. Sub-prime mortgages fit the bill. They had a higher yield because they contained an element of risk. Wall Street felt that the yield compensated for what they viewed as a small amount of risk. Indeed I interviewed a former head of a large financial services firm, who remains nameless at the moment, and he said to me, point blank, "I never thought this stuff was that risky. I was stunned when I found out." Four months later, he didn't have a job.

One question I have been grappling with is what I have come to think of as the chicken and egg question of the financial crisis. Which came first, Main Street's desire to write sub-prime mortgages or Wall Street's desire to buy them? It became very symbiotic. You could not have had one without the other. If the brokers were not writing subprime mortgages, Wall Street would necessarily have had to slow down. But Wall Street's appetite was so voracious that it helped the brokers on Main Street lower, and lower, and lower their standards. There was not anybody else to sell a mortgage to. You had to find new people because you had to feed the beast, and the beast desperately wanted to be fed.

My friend and colleague at *The New York Times*, Floyd Norris, recently wrote a wonderful column about MBIA, which was a big insurer of structured financial products, doing things that were very similar to what AIG Financial Products did.[2] They would write credit default swaps against CDOs, promising to pay off if they declined in value. The point of his column is that MBIA is now suing some of these Wall Street firms claiming that they had never been apprised of the true nature of the mortgages and the bonds. Now, that is what I call a race to the bottom. They basically admitted that they had never done the due diligence, but that was standard practice at the time.

And then there were the regulators. You have heard a lot about the Fed and the way it refused to regulate. I am sure you heard about how derivatives not only remained unregulated but were specifically given a regulatory pass in congressional legislation that became law in 1999. You have undoubtedly heard about the abolition of Glass–Steagall. I want to talk about something that is actually fairly obscure, but I think it is important. It is called Basel. Basel is an international body of bank regulators. They do not really have the power to regulate, but they develop rules that countries can then adopt for their own banking system.

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2. Floyd Norris, *A Lack of Rigor Costs MBIA*, N.Y. TIMES, Nov. 13, 2009, at B1.

Over the course of the last ten to fifteen years, there have been two iterations of Basel. One is called Basel I. The other, not surprisingly, is called Basel II. They have to do with bank's capital requirements. Capital requirements are critical to the safety and soundness of a bank, and part of the reason for this financial crisis that that the banks took excessive risks without having enough capital to back up those risks if they went bad.

That is actually the essence of the crisis we had last September and October. The banks ran out of capital. Why did they do so? Well, a lot of the reason they did so was because of these well-meaning rules that came out of Basel, which basically said that banks have to put capital aside based on the riskiness of the assets they hold.

In the old days, they just had to put capital aside based on the size of the loan—the total asset size. It didn't make a distinction between, say, a mortgage or a commercial loan or a bond. But Basel changed that. It created a risk-based system for capital requirement that allowed banks to put aside less capital for assets that were considered less risky. There were many problems with the way they weighed risk, however, starting with the fact that banks were allowed to use their own internal risk system to help decide the riskiness of the assets on their books. By the way, the rating agencies were critical in this scheme as well because the riskiness of the asset was very often based on how the rating agency rated a security.

So what happened? The banks start to game the system. Banks always want lower capital requirements because it allows them to use more of their capital for profit-making purposes. Under the rules, if you have a Triple-A asset, you have to put less capital against that than if you have a lower-rated asset. So they all start to rush to these Triple-A assets. Then if you have somebody insure that Triple-A asset with a credit default swap, then you don't have to put any capital at all.

That's where AIG enters the picture. In Wilton, Connecticut and London, AIG had a division called Financial Products. In that division, some marketers realized they could have a very good business helping banks lower their capital requirements by replacing capital with AIG credit default swaps. They called this product "regulatory capital." All they did was sell credit default swaps to banks who were trying to put less capital up against their assets. This became extremely popular, especially in Europe. And I know it is conventional wisdom to say that Henry Paulson was acting on behalf of Goldman Sachs when the government saved AIG, but I have always thought it was something else. I have always thought that what really happened was that every central banker in Europe called Paulson that weekend and said *if you don't save AIG, every bank in Europe will be insolvent*, which they would have been. And if you look at the list of people—of banks that got money from those credit default swaps—yes, Goldman Sachs is number one, but right behind Goldman is Socíeté Generale and this whole list of European banks. In any case, that is how the international regulators raced to the bottom.

I want to spend a few minutes talking about how the government has responded to the crisis. And I want to divide it into three "eras," if I can call them that. The first is from the first time we began to see trouble in the credit market—

in the summer of 2007—until Lehman weekend in September 2008. The second era is the two or three months that mark the heart of the crisis. The third is what has happened since.

In that early stage of the crisis, the government did a very poor job preparing. It turns out that when Paulson first got to Treasury, he convened a working group to come up with a plan should all hell breaks loose, because he thought it was in the realm of possibility. The Federal Reserve and the Treasury did indeed put together a plan of some sort. They called it the "break the glass" plan. (They liked terms like that in Paulson's treasury.)

As banks started to write down the assets, they never really stopped to think: *is there something systemic going on here*? They were always convinced that it was a containable problem.

There is an emerging argument in Washington and New York that maybe what the government should have done is let Bear Stearns go under because it was smaller than Lehman, and if Bear Stearns had not been saved, no one else would have been under the illusion that the government was going to save them. I don't know if that is true or not. But certainly one of the reasons Bear Stearns was rescued and sold to J.P. Morgan was that the government viewed the crisis at Bear as an anomaly—rather than a harbinger of the future. It wasn't until Fannie and Freddie had to be taken over, a week before the Lehman bankruptcy, that the government realized the depth and the extent of the problem. By which time it was really too late to do anything about it.

So the government performed very poorly leading up to the crisis. In the crisis itself, you can certainly argue—and my colleague, Andrew Ross Sorkin, in his book, *Too Big To Fail*, makes this point implicitly but eloquently—that government officials were acting like chickens with their heads cut off as they tried to "save the system." On the other hand, the TARP money was a crucial fix that stabilized the banks. The FDIC loan guarantees were important. Ben Bernanke, in particular, was very creative in the setting up of a series of guarantee programs that really loosened credit that had become almost completely paralyzed.

When you are really in the midst of a crisis, there is no plan. You have to take actions on an ad hoc basis and hope for the best. For the most part, I think, despite all the second-guessing, the government made a series of reasonable choices under extremely difficult circumstances. It stopped the bleeding.

As for where we are now, I wish I could be more optimistic. It is so hard to see how, though. Some of the most important questions are scarcely being debated—such as whether we can afford to having financial institutions that are too big to fail. If the answer is "yes," then what is the role of government in regulating those institutions? What kinds of risks should they be allowed to take—and what risks should they be prevented from taking? How should we as a society deal with these institutions?

We are in avoidance mode on that subject. Our government's implicit assumption is that there is nothing that can be done about firms that are too systematically important to fail. And we are, in effect, as a country, giving the kind of implicit government guarantee to the entire banking system that we once gave to Fannie and Freddie.

Now the interesting thing about Fannie and Freddie is that those two companies would always say *we don't have a government guarantee. Show me where it's written that we have a government guarantee.* There was no document that said there was a government guarantee, but because they were a government-sponsored entity, it was just assumed by the marketplace that they had a government guarantee. That gave them advantages in the market, such as lower cost capital than their competitors.

And then, of course, it turned out they did have a government guarantee and it wasn't implicit. They were just taken over.

So now you have a situation where Goldman, echoing Fannie and Freddie, proclaims: *we don't have a government guarantee. What are you talking about? We gave the TARP money back. Why are you so mad at us?* But the citizens of the country know absolutely they have a government guarantee, that there is no way the government will let Goldman Sachs or J.P. Morgan or Morgan Stanley or Citibank or Bank of America go under.

Secondly, proposed derivative regulation is so full of loopholes that it is hard to imagine how it will be seriously effective.

I happen to be a fan of this new consumer protection agency because I believe that you can say until you are blue in the face that other bank agencies already have the power to protect the consumer, but that will always be subsumed in the primary mission these agencies have, which is to protect the "safety and soundness" of the banking system. Unless you have a separate agency to protect the consumers, they are always going to be on the short end of the stick.

I also believe that we do need some way to handle systematic risk. I am not at all convinced that the Fed is the right agency to do it, although I really do not know what is the right agency. But let me end with this thought.

One of the things to worry about is that they are moving so fast and they have got all these different ideas, and Chris Dodd's bill is so much different than the House bill and so on and so forth. You just have no real feel about what these agencies and rules and regulations and laws are going to look like when they are enacted. We have no feeling at all for what the unintended consequences might be.

I take comfort only in the following. In 1932, Franklin D. Roosevelt became president. One of the first things he did was to slap a bunch of laws against the wall and use his popularity to push them through Congress. One of those laws created the SEC, another was Glass–Steagall, which separated commercial and investment banks, and a third was deposit insurance, FDIC, which, by the way, Roosevelt was opposed to, but it turned out to be one of the most important safety nets this country has ever seen.

People say now that these regulatory structures have broken down and that they are no longer applicable in the world in which we live, and there is a lot of truth to that. But I would make the argument that they did not really start to break down until the mid-1980s. So they lasted a good long time, fifty years, before they started to break down.

Fifty years is just long enough for people to stop remembering the era from which they came. If we get fifty years out of these next laws, we should be happy.

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Question: I remember after World War II, it took a wheelbarrow of money to buy bread. I am worried about the dollar.

Answer: Yes. It is hard to know whether we should be more worried about inflation or deflation. Both are debilitating. I am worried about inflation as well.

Let me give you a counter example that puts the problem in isolation. In 1936, after two or three years of economic growth, most people thought that the depression had ended. I read this terrific book called *The Great Depression, A Diary*, written by a lawyer in Youngstown, Ohio. He kept a diary of his life during the depression, and he kept saying that it was over. Roosevelt thought the time had come to stop deficit spending, to clamp down on the budget and stop trying to spend our way out of the crisis. But as a result, the country spiraled back into depression and stayed that way until World War II. So it is a terrible problem.

We need a national reset. Every level of society needs to spend less and go into less debt, and that will avoid the wheelbarrow problem. But that means more or less guaranteeing economic misery until the reset has taken place. In some ways, that is what the depression was—a giant reset.

So I do not think we will have that kind of inflation. I think we are all—the country and the government—too conscious of it. Bernanke's primary job is to prevent inflation. But, on the other hand, nobody is thinking hard about how to unwind the spending.

A statistic that I did not use is a startling statistic: worldwide, $17 trillion has been spent in one way, shape, or form on either stimulus, guarantees, or loans, and that is a quarter of the world's GDP. That is a pretty shocking number.

You are right. It is important to figure out how to unwind that, but I also think it is: (A) too early and (B) nobody really knows how to do it.

Question: What would you do about executive compensation?

Answer: Well, from a social point of view, I have thought for a very long time that it is just too darn high and that it creates fractures in the country. It creates a country of haves and have-nots, but trying to do something about it turns out to be much more difficult than you think.

The pay czar, Ken Feinberg's solution, which is to cut cash and give the Wall Street executives more stock, is going to wind up enormously enriching them because the stocks are so low now that inevitably we know that Bank of America and Citibank are going to recover to some extent. It seems inevitable.

Every effort to contain executive compensation has generally backfired. So I have come to the view that the way to deal with it is not to try and focus on executive compensation itself, but to deal with the broader governance issue. If you made it easier for shareholders to vote directors off boards when they are displeased with the compensation of the executives, you would solve 80% of the problem because directors do not want to be voted off.

Executive compensation consultants say that executives are much more attuned right now to the mood of the country than the CEOs, who are still grasping for every last dollar. And ultimately the board sets the pay.

If you had a system where shareholders could vote people off boards, people who were on the compensation committee and had egregiously overpaid somebody or paid somebody for nonperformance, you might be able to solve the problem.

Question: Where do you think things would have been had Glass–Steagall not been repealed?

Answer: Well the problem is that Europe does not have a Glass–Steagall. So if Citibank had not been able to merge with Smith Barney, Travelers and all the rest of them, J.P. Morgan and Chase would not have merged, you still would have had the crisis.

The issue is not too big to fail. It is too systematically risky to fail. So you still would have had J.P. Morgan, Goldman Sachs, Deutsche Bank, UBS trading in these securities. You still would have had the European Basel II gaming and so on and so forth.

Even if Glass–Steagall had not been abolished, we still would have had big banks being stodgy losers in the eyes of investors. A lot of this had to do with return on capital; they wanted the stock prices to go up. But it would have been good for the country had Glass–Steagall not been abolished.

Another thing that tends to get overlooked: securitization, at this point, is as important as or more important than banks are to lending. Part of the reason there is so little lending going on right now and borrowing is such a struggle is because the securitization market has not revived.

So even if Glass–Steagall had not abolished, there still would have been a giant securitization market that enabled lending. So it would have made less difference than many people now believe. The abolishment of Glass-Steagall was symptomatic: it was code for *they did not care about regulation.*

Question: What advice would you give to people right now?

Answer: Well, individuals need to act in their own best economic interest, but for most people their own best economic interest right now is indeed to pull back on their debt, and to pay down their home equity loan. Do not pile up a bunch of new credit-card debt.

The government should not be encouraging people to spend at this point. If a stimulus is necessary, the government should do a stimulus. But for most of us who have found ourselves awash in debt and mindlessly taking out home equity loans to go on vacation, that behavior is unsustainable. It is unsustainable if we are going to have any kind of sound economy that's not completely dependant on China buying all our treasury bills.

Question: If there were only two things that the government should do during the next twenty-four months, based upon your experience and your thoughts, what would they be?

Answer: Well, to me the most important thing is to have an open, honest debate about too big to fail. I think too big to fail will lead us to the next precipice if we do not do something about it. That is on my personal agenda; that is the most important thing. I really do not have a number two.

England is actually having a serious, legitimate debate about this with its Chancellor of the Exchequer and the head of its version of the SEC and is basically arguing strongly that too big to fail is unsustainable in England. Of course, they have a different problem there, which is that the financial sector is so big in England that the assets of the five largest banks in England are five times the country's GDP.

It is easy to see why they might want to have this discussion. The politicians in England are basically saying *no, things are fine*—but they are having an important public discussion that we are not having.

This discussion can take place in the halls of Congress. I covered Congress when I was in my mid-twenties. I then became a business reporter and did not think about Congress for twenty-five years. Going back there now and sitting in these hearings, it is just appalling. Putting aside the sort of lunacy of some of the things they say and do, do you know how many members of the house financial services committee there are? Seventy-two.

How do you get anything done? They all want their five-minute speech. So five times seventy-two, plus the responses.

In the 1930s, we had the Pecora Committee—a committee of Congress, and Pecora was the Chief Counsel. A lot of what they did was incendiary, and a lot of it was designed to make people hate banks, so that they could pass regulation. I acknowledge all that, but it was two years of sustained investigation where people actually went to jail as a result, and things like the SEC could pass quite easily because the public had really been informed about the sins of the previous era.

We do not have anything like that. We have not started down that path, and I think it is tragic. That is what I think the country should do.

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