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Getting the Story Backwards

THE 2008 ECONOMIC CRISIS is desperate for culprits. Was it Wall Street fat cats and their $100-million bonuses and retirement packages? Predatory mortgage brokers who lent money recklessly? Hedge fund speculators who took enormous leveraged bets? Alan Greenspan and the Fed who failed to regulate? Subprime borrowers who tried to buy homes they couldn't afford? Or how about the rest of us, who piled up debt on multiple credit cards? (The Wisconsin folks might also add a few desperado banks and investment houses to the list.)

When faced with such a catastrophic and complex set of events, the media defaults to a misery-loves-company collective narrative: "We're all to blame." We all lived beyond our means and now we're paying the price. From the elite billionaire hedge fund operator to the poor schmo with no equity who thought he could gamble on a $400,000 home, we all lived too high on the hog. In Wisconsin the collective tale of woe might run from the retired school employees who thought they had earned their medical benefits to the school board officials who wanted to get into the Wall Street scams, to the brokers, banks, and investment houses who hoodwinked the local school boards. In every locale, it's time each of us takes full responsibility for our profligate ways. Repent, ye sinners, repent!

The narrative has appeal. When we feel a collective hurt, it is soothing to share it during times of crisis. But this story never happened. We may have been living beyond our means, but very few of us had anything to do with the meltdown or the financial toxic waste that is polluting the economy. While many of us may

enjoy an occasional game of penny-ante poker, only the elite can play fantasy finance.

But wait, what about the bursting housing bubble, which set off this whole crisis? Wasn't it caused by marginal buyers who got mortgages even though they had no way to pay them off? And didn't those big government-sponsored mortgage agencies, Freddie Mac and Fannie Mae, let those low-income buyers in?

Conservatives are pushing this line of attack, which conveniently preserves their free-market ideology. The culprit was government—once again!

Their case starts by pointing the finger directly at Democrats, who supposedly pressured mortgage lenders to relax standards for lower-income minority buyers. In this scenario, guilty liberal politicians first passed the ill-advised Community Reinvestment Act in 1977 to force banks to give mortgages to low-income minorities, and then pressured Freddie Mac and Fannie Mae to buy up these risky mortgages.

Larry Kudlow, CNBC's free-market apostle, spelled it all out for MSNBC's Joe Scarborough, the former Republican congressman from Florida. (Full disclosure: In 1970 Larry and I worked together in Connecticut, along with Bill Clinton, in a losing effort to elect anti–Vietnam War candidate Joseph Duffey to the U.S. Senate. At the time Kudlow seemed liberal while palling around with pinkos.)

> *Kudlow*: It's time for the Congress, Republicans and Democrats to stop encouraging—exhorting and forcing banks to make low-income loans with no documentation. Stop that—literally pushed these lenders to make-low income loans.
>
> *Scarborough*: Hold on a second. You cannot blame this on low-income people that are getting a house.
>
> *Kudlow*: I'm not blaming them. . . . Subprime, substandard loans were a creature of the U.S. Congress in the '90s and the 2000s.

Scarborough: Are you saying that poor people have caused this crisis?

Kudlow: Not poor people. Members of Congress who were rich people. But their liberal guilt consciences forced banks and lenders to make lousy substandard loans and that has to be repealed. . . . Not everybody can afford a home, Joe. Some people have to rent. . .

Scarborough: That was Larry Kudlow of CNBC's *Kudlow and Company*, 7 p.m. tonight where you'll also learn on that show that it was the poor people who were also responsible for the Kennedy assassination. [laughter][1]

Let's start with the Community Reinvestment Act (CRA). There is scant evidence that it has had a substantial impact on the housing bubble and bust, let alone on the broader economy. The Act did indeed ask banks to make more loans to low-income community residents. The bill was designed to stop de-facto discrimination, called "red-lining," which disqualified entire neighborhoods from receiving loans. Minority applicants from those neighborhoods were denied mortgages even when they had better financial qualifications than comparable buyers in white neighborhoods. Before the House Committee on Financial Services on February 13, 2008, law professor Michael S. Barr, a former Clinton administration Treasury official, put CRA's role in perspective:

> More than half of subprime loans were made by independent mortgage companies not subject to comprehensive federal supervision; another 30 percent of such originations were made by affiliates of banks or thrifts, which are not subject to routine examination or supervision, and the remaining 20 percent were made by banks and thrifts. Although reasonable people can disagree about how to interpret the evidence, my own judgment is that the worst and most widespread abuses occurred in the institutions with the least federal oversight.[2]

Janet L. Yellen, president of the Federal Reserve Bank of San Francisco, also recognized a distinct difference between CRA lending and the subprime housing crisis. On March 31, 2008, she said:

> There has been a tendency to conflate the current problems in the subprime market with CRA-motivated lending, or with lending to low-income families in general. I believe it is very important to make a distinction between the two. Most of the loans made by depository institutions examined under the CRA have not been higher-priced loans, and studies have shown that the CRA has increased the volume of responsible lending to low- and moderate-income households.[3]

Traiger & Hinckley LLP, a law firm that advises financial institutions on CRA compliance, also finds no evidence that CRA contributed to the subprime crisis. In their third annual analysis of publicly available home-purchase mortgage-lending data, they write, "Our study concludes that *CRA Banks were substantially less likely than other lenders to make the kinds of risky home purchase loans that helped fuel the foreclosure crisis*" (emphasis in the original).[4]

The heaviest artillery conservatives fire against Freddie Mac and Fannie Mae comes from "The Last Trillion-Dollar Commitment," written by Peter J. Wallison and Charles W. Calomiris for the American Enterprise Institute. The authors argue that the whole idea behind Freddie and Fannie is flawed. The government created them to facilitate home ownership by buying mortgages from local banks and mortgage companies and then selling them as securities to investors. And yet they are (were) private operations with stockholders and CEOs who sought to maximize shareholder returns and CEO compensation. Because they had the tacit backing of the federal government, Fannie and Freddie could secure cheaper funding in the capital

markets and therefore had an unfair advantage over firms in the private sector. The authors contend that Fanny and Freddie took too many risks because they knew that in a pinch, the government would bail them out (and it did).

The authors claim that Freddie and Fannie—the giants of the mortgage field—got the whole financial crisis rolling back in 2004, when they first began investing heavily in junk mortgages. They write, "It is likely that this huge increase in commitments to junk lending was largely the result of signals from Fannie and Freddie that they were ready to buy these loans in bulk."[5] Boom. The race was on and major financial intermediaries around the world got into the act. And then it all came crashing down.

Wallison and Calomiris argue that Fannie and Freddie fundamentally distorted the market. "The special relationship with Congress was [Fannie's and Freddie's] undoing because it allowed them to escape the market discipline—the wariness of lenders—that keeps corporate managements from taking unacceptable risks."

National Journal columnist Stuart Taylor put it more starkly. He writes that Wallison and Calomiris showed that "Fannie and Freddie appear to have played a major role in causing the current crisis, in part because their quasi-governmental status violated basic principles of a healthy free enterprise system by allowing them to privatize profit while socializing risk."[6]

The *Washington Post* editorial board goes one step further: "We are not witnessing a crisis of the free market but a crisis of distorted markets."[7]

Free markets good. Government interference bad. Freddie and Fannie, the nation's biggest mortgage buyers, were pressured by liberals to bring the American dream to poor people. And because they "escaped the market discipline . . . that keeps corporate managements from taking unacceptable risks," they agreed to give mortgages to those who had no business buying homes. Everyone who invested in these mortgages got shafted; they had to sell the houses on the cheap to recoup some of their losses.

And this brought down entire neighborhoods as housing values crashed. Foreclosures spread. Financial institutions and investors suffered more losses, banks and investment houses collapsed. The whole banking system teetered. Credit froze and then the entire economy tanked. And it's all the government's fault—especially Kudlow's bleeding-heart liberals.

Not quite. Wallison, Calomiris, and company have it backwards. "Market discipline" did not tame "corporate management from taking on unacceptable risks." The financial industry fiercely competed to create the wildest casino ever: the bigger the risks, the bigger the profits. Market discipline (the competitive drive for profits) drove them forward rather than held them back. Free-market ideologues can't handle the obvious: unregulated financial markets crashed *on their own*, and are threatening to take all of us down with them. In fact, free-market discipline failed so calamitously that the freedom-loving Bush administration had to socialize much of the banking system. Talk about eating crow!

As for Fannie and Freddie, they did not cause our current meltdown. And the bad mortgages they bought were not the result of either the Community Reinvestment Act or their lack of exposure to market forces. This is not to say that Fannie and Freddie were paragons of public virtue. They were a mess. But if anything, market pressures drove them to join the derivative casino. They didn't invent it.

Deconstructing a few esoteric lines from Wallison and Calomiris' indictment of Fannie and Freddie might help lead us to the real culprits.

> Without [Fannie's and Freddie's] commitment to purchase the AAA tranches [slices] of these securitizations, it is unlikely that the pools [of subprime mortgages] could have been formed and marketed around the world. . . . Accordingly not only did [they] destroy their own financial condition with their excessive

> purchases of subprime loans in the three-year period of 2005–2007, but they also played a major role in weakening or destroying the solvency and stability of other financial institutions and investors in the United States and abroad.[8]

Consider the colossal contradiction contained in this passage: How can something have an AAA rating (the highest, safest debt rating provided by the credit agencies) and at the same time be connected to "subprime loans"? An AAA-rated security is supposed to be very, very safe and should have posed absolutely no problem to Fannie, Freddie, or any other investor around the globe. But if it was really subprime junk, how did it get a triple-A rating? Fannie and Freddie can be justly blamed for many indiscretions, but how can you blame them for buying AAA-rated securities?

Well, my hedge fund source informs me that "by this time, people already knew that the ratings were complete bunk." So Fannie and Freddie should have known that they were gambling and not making sound investments. This is no doubt true. But as economist Dean Baker states in his excellent account of the crisis, "It's important to point out that Fannie and Freddie followed the private sector into this area. In fact, they lost market share to the private-sector in this area."[9]

But there's a larger conceptual problem that the Kudlow conservatives choose not to address. The entire subprime mortgage market totals "only" $1.3 trillion—about 2 percent of our nation's household net worth. Credible estimates for the losses incurred owing to subprime loans and the next riskiest class of loans, "Alt-A," together total about $300 billion (divided equally between the two types of risky loans).[10] How could that amount devastate the world economy? Or look at it this way: If the potential high-risk mortgage defaults totaled only $300 billion, then surely the trillion-dollar federal bank bailouts would have covered the entire problem, and then some. But they didn't.

No, something else far more powerful and insidious was at work, and the clues hide in those AAA securities that were created out of junk debt.

What are they? Why did they go bust? And how did they crash the financial system?

As we entered the twenty-first century, the economy experienced severe stresses and strains. The dot.com bubble inflated and burst, and then 9/11 hit. As the economy slid into recession, Alan Greenspan's Fed responded by dramatically lowering interest rates. Many believe this overstimulated the housing sector. It certainly opened vast new vistas for derivatives. Greenspan, who had already beaten back attempts to regulate derivatives, was supremely confident that financial free markets could police themselves. Referring to this period, he wrote in his memoirs, "The worst [derivatives] have failed; investors no longer fund them and are not likely to in the future."[11]

Unfortunately for us, this was not Greenspan's most prescient observation. The worst derivatives were about to latch onto the housing boom like the creature in *Alien*.

When interest rates go down significantly, especially long-term rates, mortgage rates go down. This, in turn, increases the demand for homes. With lower interest rates, you get lower monthly mortgage payments, so you can more easily afford your first home, a better home, or a second home. It's also easier to find buyers for your existing home. At the same time, lower interest rates help home builders finance their projects thereby increasing the supply of houses.

What's more, when interest rates go down, the value of assets increases. I always found that a bit strange, but here's the example I tell myself to make it clearer. Let's say you own a 30-year, $10,000 government bond that pays 6 percent. That means it provides you with $600 each year in interest payments. Imagine that long-term interest rates fall dramatically, and now the

government is selling 30-year bonds with a 3 percent interest coupon. So the new $10,000 bonds will only provide $300 a year in interest payments. Obviously, your old 30-year bond is now a lot more valuable. In fact your old bond (depending on how close to maturity it is) would probably fetch more like $20,000 (since 3 percent of $20,000 = $600). So that asset is definitely up in value. A house also is an asset, and declining interest rates increase its value as well. And when asset values rise, we feel richer and are willing to spend more. When people see their homes go up in value, they take out more home-equity loans to remodel the kitchen, buy a new car, or send the kids to college.

So put it all together—very low mortgage rates, low interest rates for builders, rising home values, and increased demand for homes—and you have the makings of a housing boom. But that does not fully explain the explosion in housing prices that started just before the turn of the century.

While the rest of us saw just a housing boom, the derivatives industry saw a gold-plated casino, the biggest one ever. The world was about to become their private Las Vegas. They were more than ready for the action since they had already packaged a set of derivative games perfectly suited for the housing casino.

Financial innovations come about to solve specific financial problems. Here was the problem. A bank loans you money so you can buy a house. The bank gets an upfront fee (usually from 1 to 3 percent of the total mortgage, referred to as points), a very nice revenue for the bank or mortgage company. Then the bank gets principal and interest payments back from you each month over the next 15 or 30 years. That's a very long time to tie up the bank's money. The bank would prefer to get those loans off their books so that they can issue more and more mortgages and earn the juicy up-front points. That's where the real money is for the bank. Waiting around for the principal and interest to come in isn't nearly as lucrative. So the idea is to get rid of the loan—to sell it off to someone else.

During the Depression when the housing market had ground

to a standstill, the New Deal (not the private sector) created the financial machinery to solve this problem. It established Fannie Mae in 1934, and it bought up local banks' mortgage loans—so long as the borrower had a decent income, a good job record, and a substantial down payment.[12] The originating bank continued to service the loan, collecting the mortgage payments on behalf of Fannie Mae. But the loan was no longer on the local bank's books, so the bank had more capital to loan out again. Fannie Mae then sold the loans to investors, with a federal guarantee that the loans would be paid back even if the homeowner defaulted.

Twenty years later, the federal government invented another key instrument—mortgage-backed securities. These were developed for mortgages arranged by government agencies like the Veterans Administration and the Office of Public and Indian Housing. To more efficiently sell these loans to investors, in 1968 Congress set up a new agency, the Government National Mortgage Association (Ginny Mae). It pooled all these government-backed loans and chopped them up into securities. (*Security* is just another word to describe a financial instrument, one that is transferable and has value because of its income flow; *securitization* is the process of creating these securities from income flows that previously could not be easily bought and sold. Each pool of thousands of mortgages could be chopped up into hundreds of individual securities.) Ginny Mae then sold the securities to investors, all backed by the federal government. Each pool contained thousands of single-family loans that conformed to good government lending standards. Every slice of what Ginny Mae offered from a given pool was identical—and Ginny Mae paid back each investor's share of the returned principal with a set interest rate.[13]

This was problematic for some investors—you didn't know how long the security would last because sometimes the underlying mortgages would be paid back early. If interest rates declined many homeowners would rush to refinance. When they did, that

mortgage would leave the Ginny Mae pool and the investors would get back their share of the remaining principal immediately. You wouldn't lose any money, but many investors wanted to know exactly how long their investments would last.

This uncertainty provided an opening for traders. They soon created financial products (derivatives) that more or less pulled Ginny Mae interest payments and principal payments apart. For a fee, you could buy a Ginny Mae derivative that gave you a fixed rate of interest for a fixed period of time, or you could buy into the principal payments, essentially taking a bet on how fast the homes refinanced.

It was just a short hop, skip, and jump for derivative dealers to see that there was a huge mortgage market out there that had nothing to do with the federal government. Specifically, there were marginal buyers whose mortgages were not prime ("A-paper"), but rather "Alt-A" (for Alternative A-paper, a little riskier than prime) or even subprime. These buyers didn't qualify for federal subsidies, and weren't included in Freddie and Fannie's mainstream federal loan repurchases.

Ah ha! Marginal buyers = higher interest rates = higher fees. Very appealing, especially in an era of declining interest rates—provided the risk of default could be contained. Why not borrow Ginny Mae's strategy for these more marginal buyers? If we can pool these risky loans and "securitize" them, we can sell the pieces to investors all over the world. Derivative dealers could make money by forming and selling the securities, and by trading them in a secondary market. No doubt financial engineering geniuses could use them as a platform to derive more and more derivatives so that hungry investors could do some additional speculating.

But, on second thought, simply copying the Ginny Mae format wouldn't do. Because these subprime pools would be risky, the new mortgage-backed securities, unlike Ginny Mae securities, would never be rated AAA (the highest rating). And of course they wouldn't have the government's backing.

Subprime mortgages were just too risky. In fact they were more

or less the equivalent of junk bonds—a very speculative investment. And this would limit the investor market. Many institutional investors are prohibited from making large investments in speculative securities. For example, pension funds, insurance companies, and banks often are restricted to purchasing securities with at least "investment grade" ratings, and explicitly prohibited from buying anything with junk status (meaning they are too risky to receive a rating). So pooling the subprime mortgages just wouldn't do. Back to the drawing board.

Enter the financial engineering geniuses. First there was a fellow named Larry Fink, who in 1983 worked with a team at First Boston Bank on behalf of Freddie Mac. Fink came up with an invention called a collateralized mortgage obligation (CMO), designed to work with a pool of low-risk mortgages that conformed to Freddie and Fannie standards.

Author Satyajit Das claims that "Michael Milken, the junk bond king, created the first CDO [collateralized debt obligation] in 1987 at now-defunct Drexel Burnham Lambert Inc."[14] He expanded Fink's idea to work with a pool of junk bonds. It quickly turned into a humongous winner . . . until becoming a world-record-breaking loser. (Please listen up all you folks from Whitefish Bay, Kenosha, Kimberly, Waukesha, and West Allis–West Milwaukee. This is where your story really starts.)

Here was the idea. Let's gather together these marginal subprime mortgages into big pools. But when we slice up each pool into securities, unlike at Ginny Mae, we'll slice them up *unequally*. We'll chop up the pool so that *risk and the rate of return varies by slice*. We'll design some of the pieces so that they are very secure while others will be far riskier. The more secure pieces will get lower rates of return and the very risky pieces will get much higher rates of return.

How is that possible? First and foremost, you've got to add some continental charm and sophistication to your nomenclature.

Instead of slices, the derivatives industry adopted the French word for slice—*tranche*. Sounds more secure already! Next comes the imaginative financial engineering.

Imagine a pool of a thousand subprime mortgages—a large collection of loans backed by homes whose buyers have less than stellar credit ratings. They might not have made a down payment on their home—they might not even have a job. Every month most of them, actually nearly all of them, will still make their mortgage payment. People don't like to lose their houses, even if they can't really afford them. Every once in a while, someone in the pool will default, but the historical record shows that more than 85 percent of the people will keep on paying. So this large pool as a whole will generate each month a robust flow of income from the mortgage payments.

The clever derivative folks figured out that you can create securities from that pool that have very different amounts of risk. Here's a very simple example.[15]

Let's slice that pool into three tranches of securities—high, medium, and low. We give the securities in the high tranche (called the senior tranche or super-senior tranche) first dibs on *all* the interest payments coming out of the pool. To really protect the investors who buy securities from this highest tranche, you can set it up so the senior tranche would get interest payments even if the default rate were several times the historical average for subprime borrowers. So by giving senior tranche first claim on all the interest payments from the entire pool of subprime loans, you've taken away much of the risk for the investors who bought senior tranche securities.

Your middle tranche (called the mezzanine tranche, naturally) would be slightly less protected; it would have to absorb losses if the default rate hit maybe two times the historical average. Securities drawn from the mezzanine tranche would have more risk than the senior tranche but would still be much safer than investing in the pool as a whole.

Finally, you've got your bottom tranche (called the equity

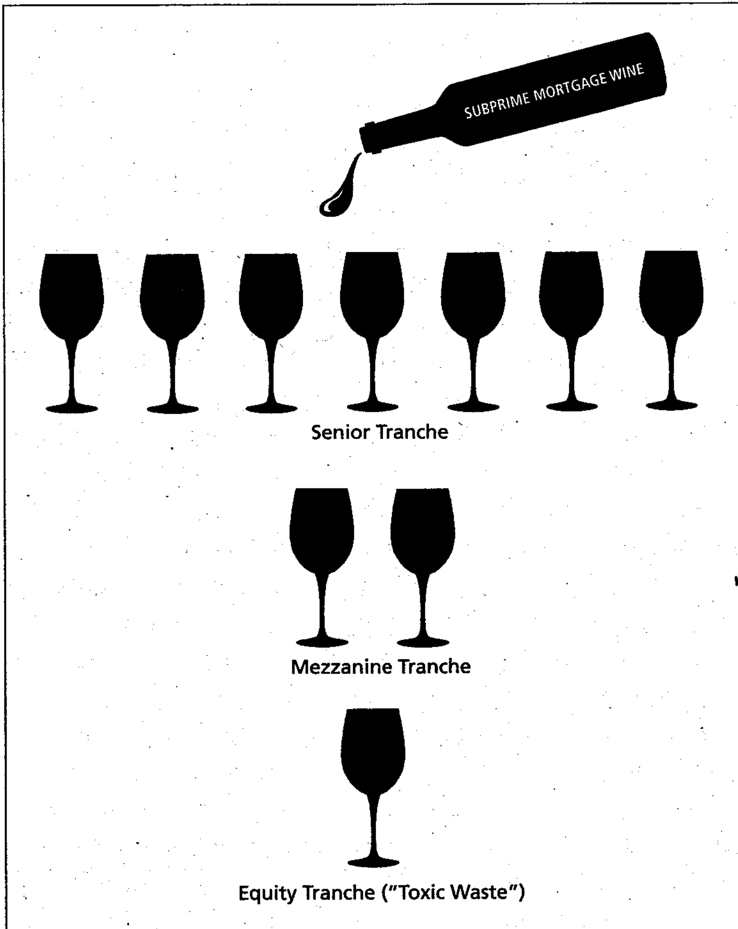
tranche because equity—aka corporate stock shares—in case of bankruptcy, also has the lowest and last claim on assets). This tranche takes the first hit on defaults. It is saddled with the bulk of the risk of the entire pool.

Since the risk varies for each tranche, the rates of return also vary. The senior tranche, being the safest, would get a lower rate of return. The mezzanine would get a higher rate, and the equity tranche would get an enormous rate of return—20, 30, or even 40 percent per year (so long as defaults on the underlying mortgages stay low)—because it was shouldering nearly all of the risk for the entire pool.

Here's a visual analogy.[16] Imagine a wine bottle and an upside-down pyramid of wine glasses with three levels. The top layer has seven glasses, the middle has two, and the bottom just one. The wine bottle is the pool of subprime mortgages. The wine in the bottle is the sum of all the interest payments from the subprime mortgages. Each wine glass in our upside-down pyramid represents a financial security that is sold to investors. Each row is a tranche. You start pouring the wine (interest) from the top down to pay the investors. The senior tranche is the top row and it gets the first servings of wine. The middle row, the mezzanine tranche, gets served next, and the bottom glass in the equity tranche is last to be served.

If some of the subprime mortgages backing the CDO default, there is less wine to be poured for all the glasses, but the top glasses are first in line to get filled to the brim. If the wine runs out before it reaches the bottom-tranche glass, too bad—that's the risk you take when you buy that glass.

So far so good, but not good enough. To build a massive global market for the top tranche of wine glasses, you need to get high ratings from one of the three major ratings agencies: Moody's, Standard and Poor's, or Fitch's. If you could get one of them to give you AAA ratings for the senior tranche, you could market it to pension funds, insurance companies, banks, and the like. Big, big money.



That is precisely what happened. Derivative houses were able to convince the rating agencies that the top tranche was supersafe and should be rated AAA, virtually as good as you can get without being backed by the federal government. How they pulled this off is a longer story that we'll return to later. But for now all we need to know is that the derivative bankers secured AAA ratings for the top tranche. They also secured decent investment-grade ratings for the mezzanine tranches. The lowly equity tranche, however, got stuck with junk-bond status.

From the start, the derivative dealers called it "nuclear waste" and "toxic waste."

In theory this makes some sense. Our top row of wine glasses is protected by the two rows below it. It would take many failures within the wine bottle for there not to be enough wine to fill the top tranche of glasses. However, the creators of these securities also wanted there to be as many wine glasses in the top row as possible, and they wanted them rated AAA—which is what happened. They were remarkably successful in getting AAA ratings for the entire top row—up to 80 percent of all the securities in a CDO. Nice work.

Here's the kicker: Not only were the senior tranches rated AAA, but they came with a *higher* rate of return than other sorts of AAA securities (like GE or AIG AAA-rated bonds). So the top row of glasses became hot commodities for investors from the northern tip of Norway to the eastern shores of Wisconsin.' A massive global market opened up for derivative dealers.

Let's pause to admire the true alchemy of this financial engineering. You take a bunch of subprime mortgages from marginal borrowers, and you put them in a big pool (your wine bottle). You divide up the pool into securities (your wine glasses), but you don't divide them up equally. Each tranche (row of wine glasses) gets a different rate of return based on how much risk it assumes. Because the top tranche assumes relatively little risk, it gets a lower return, but also gets rated AAA—and it has a higher interest-rate coupon than other AAA securities. Kind of amazing, given that none of the mortgages in the pool either on their own or bundled together could possibly earn such a rating. After all, each mortgage in the pool is risky, far below Freddie Mac standards.

Yet with a bit of French vocabulary and fancy wine pouring, our financial engineers turned a very large chunk of the pool (75 percent or more of it) into AAA-rated securities. It's a miracle. This new derivative, which generically is called a collateralized debt obligation (CDO)[17]—which includes all the tranches—

turned about three-quarters of the sow's ear into a highly profitable silk purse.[18]

What about the risky equity tranches—the bottom row of glasses that might stay dry? You would think no one would want to drink from a glass labeled "toxic waste." You would be wrong. The potential high returns for the equity tranches were so alluring that often the originating bank held on to them, or sold them at a profit to speculators who lined up for them. They even pawned them off on pension funds. The largest investment houses and banks (like now-defunct Bear Stearns, Merrill Lynch, and Wachovia, and others who survived) engaged in a highly successful and profitable campaign to unload billions of dollars of subprime equity tranches onto state pension funds covering public employees.[19] According to "The Poison in Your Pension," a Bloomberg Markets report issued in July 2007, state pension funds purchased 18 percent of the riskiest CDO equity tranches, but only 4 percent of the higher AAA-rated tranches.[20] You can bet there now are some empty wine glasses in those pension funds.

For a while the wine flowed freely. During the housing boom the mortgage-default rate was extremely low, even for subprime borrowers. And with home prices rising, subprime-mortgage holders expected to get most of their money back even if the house had to be foreclosed and sold. So for aggressive investors, at least in the short run, the equity tranche seemed more than worth the risk. If defaults started to inch up, the banks figured they would be the first to spot it and could unload the toxic waste before it polluted their books. And as we'll see in a bit, you could even buy derivative insurance to reduce the risk of the equity tranches.

If your eyes are glazed over from all this wine, just remember one important point: this was a money machine for the derivatives industry. The alchemists walked away with billions of dollars in fees for organizing the pools, creating the securities, marketing them, trading them, and collecting the big returns from the equity tranches. We don't know what percentage of bank profits came from these derivatives, but we can be sure that

it was high—amounting to tens of billions of dollars. Traders got enormous bonuses. Their bosses got a nice piece. Many golden parachutes—those robust executive retirement packages—were stitched together with CDO profits.

This wasn't just wine. It was Dom Perignon.

We now should know enough to kiss goodbye the fairy tale about how those greedy, reckless subprime borrowers or the big, bad Freddie/Fannie agencies drove us into the ditch. They did not create this derivative bonanza.

The CDOs—and the process that created them—were so profitable they generated enormous demand for subprime mortgages among profit-hungry CDO packagers. In fact they propelled a global conveyer belt of subprime mortgages. Investors all over wanted the higher returns offered through the CDO tranches. Derivative dealers in banks rushed to fill the demand by creating the new securities, sucking up all the subprime mortgages they could get their hands on. Mortgage companies out in the field knew that they could quickly sell the loans they wrote so they scrambled to find clients. After all, the more loans they wrote the more fees they would earn. Besides, it made economic sense to offer a wide variety of loan products that would allow all kinds of people to buy homes. Adjustable rates, teaser rates, no income verification, no down payments, interest only, interest tacked on to the principal, predatory loans, loans to dead people—it didn't matter as long as the mortgage broker got the closing fee and could pass on the mortgage to a CDO packager immediately.[21] It didn't matter if the borrower's application was science fiction. No one was checking. Let 'er rip.

This demand for more subprime mortgages for the CDO pools naturally lured more marginal buyers into the market and increased demand for houses. And of course, many of these buyers were eager to take advantage of the lax standards. This increased home prices and encouraged more home building. What if the

homebuyer couldn't make his monthly payment? Not a problem. Prices were rising quickly. Even if the mortgage went into default, the home could be resold for as much as or more than the outstanding loan.

It was so American: The casino was pumping out enormous profits for the derivative gang. Speculators were buying and selling houses and raking in the bucks. And even low-income homebuyers got a peek at the Promised Land.

But not for long.