This American Life Episode Transcript
Program #355
The Giant Pool of Money

[Ambient sound of piano playing and crowd murmur]

Ira Glass: So Adam, where are we?

Adam Davidson: I recorded this at the Ritz Carlton in lower Manhattan. It's a black tie dinner, just a few weeks ago.

Ira Glass: And you, by the way, are NPR's International Business and Economics correspondent.

Adam Davidson: That's right. I was there for my job. They're giving out awards for all these financial securities, including the one that nearly brought down the global financial system. You know, the whole sub prime mortgage crisis.

> Jim Finkel: This guy is a legend. He's a granddaddy of our industry.

Adam Davidson: I'm sitting at this dinner with Jim Finkel. He's kind of nervous because he's up for CDO of the Year for the CDO he created, Monterrey. Now, the CDO, that's what we're talking about, that's the financial instrument that was central to this global credit crisis we're in.

Ira Glass: And they're giving awards for this? These guys are giving each other awards for doing that?

Adam Davidson: Let me just say, they're aware that there's a certain irony, giving awards to the instrument that almost destroyed the world's economy. They did consider canceling this year but it's been a really tough year, it's been really gloomy for them.

> Jim Finkel: Honestly, I know this sounds...I was happy to see there were no major suicides, people weren't jumping off bridges, there weren't personal disasters.

Adam Davidson: That same week, a few days earlier across the river in Brooklyn, I went to a completely different kind of gathering. It was not black tie. It was put on by the Neighborhood Assistance Corporation of America. It was people on the opposite side of the mortgage crisis. People facing foreclosure, trying to figure out how to keep their homes. I met this one guy Richard, he's a Marine. This big guy, over six feet tall. When he came back from Iraq a few years ago he bought one of these fancy new mortgages with an adjustable rate. Recently his rate reset. It's gone up by more than $2,000 a month and he's fallen behind on his payments.

> Richard Campbell: At one point, my son had $7,000 in a CD and I had to break it. That really hurt. I was saving that money for his college. I put $2,000 back but it's like you can't have a future. They put you in a situation where after a while you're going to fail. It's hard.

Adam Davidson: It's clear these two groups are connected. Jim at the black tie dinner and Richard the marine. The sub prime crisis has connected them.

Ira Glass: Right. And I know this is what sent you and one of the producers of our show, Alex Blumberg, on a big reporting mission these last few months. You saw that. That there's this long chain of people that starts with these Wall Street guys and ends with people who stand to lose their houses. All along that chain there were bankers and brokers and investors and homeowners. Everybody deluded themselves, thinking they could throw out the old rules of banking.

Adam Davidson: Right. In all the coverage of this we hadn't heard much from the people all along the chain. We wanted to know what where they thinking when they were doing all this? And why did they think it would work? And simply, how did it all work?

Ira Glass: So, this is what we're devoting our program to today. From WBEZ Chicago, it's This American Life distributed by Public Radio International. I'm Ira Glass. And today's show is a special co-production we're doing with NPR News – your place of employment Adam.

Adam Davidson: Very proudly so.

Ira Glass: You and Alex Blumberg are going to be explaining step by step how this all worked and we'll meet some of the people who created this economic disaster. Let me turn the show over to the two of you, which is great for me because I've pretty much lost my voice anyway. Alex Blumberg will kick things off.

Music

Alex Blumberg: The thing that got me interested in all this was something called a NINA loan. Back when the housing crisis was still a housing bubble. A guy on the phone told me that a NINA loan stands *for No Income, No Asset*, as in, someone will lend you a bunch of money without first checking if you have any income or any assets. And it was an official, loan product. Like, you could walk into a mortgage broker's office and they would say, well, we can give you a 30 year fixed rate, or we could put you in a NINA. He said there were lots of loans like this, where the bank didn't actually check your income, which I found confusing. It turns out even the people who got them found them confusing. For example, a guy I met named Clarence Nathan. He worked 3 part time, not very steady jobs, and made a total of roughly 45 thousand dollars a year roughly. He got himself into trouble and needed money, so he took out a loan against his house. A big one.

Clarence Nathan: Call it 540 for round figures

Alex Blumberg: And you basically borrowed that from the bank and they didn't check your income?

Clarence Nathan: Right. It's a no-income verification loan. They don't do that. It's almost like you pass a guy in the street and say: lend me 540,000 dollars? He says, what do you do? Hey, I got a job. OK. It seems that casual even though there are a lot of papers that get filled out and stuff flies all over with the faxed and emails. Essentially, that's ... that the process.

Alex Blumberg: Would you have loaned you the money?

Clarence Nathan: I wouldn't have loaned me the money. And nobody that I know would have loaned me the money. I know guys who are criminals who wouldn't loan me that and they break your knee-caps. I don't know why the bank did it. I'm serious ... 540 thousand dollars to a person w/bad credit.

Alex Blumberg: As it turns out, Clarence's friends, acquaintances and shadowy criminal contacts would have been right not to lend him money. At the time I talked to him, Clarence hadn't made a payment in almost a year, and his house was in the process of foreclosure.

Stories like this have been in the news for months. They often feature an innocent homeowner who was duped by a lying, greedy mortgage banker. Or, if you're more of a Wall Street Journal editorial page type, an innocent mortgage banker who was duped by lying, greedy homeowner. No doubt, both categories exist, but Clarence's case is more nuanced...and much more common:

Clarence Nathan: Nobody came and told me a lie: just close your eyes and the problem will go away. That's wasn't the situation. I needed the money. I'm not trying to absolve myself of anything. I thought I could do this and get out of it within 6 to 9 months. The 6 to 9 month plan didn't work so I'm stuck. If somebody had told me I couldn't borrow the money I probably would've had to do something else more drastic and dramatic and not be in this situation now. The bank made an imprudent loan. I made an imprudent loan. We're partners in this.

Alex Blumberg: This imprudent partnership is new, and is at the heart the current housing crisis. For most of the history of banking, bankers wouldn't have loaned Clarence their money either. They didn't let people like Clarence near their money, in fact, people with part-time employment, and unpaid debts in their past. And then, suddenly, in the early 2000's, everything changed, banking turned on its head and went out looking for partnerships with people like Clarence...loaning him half a million dollars without even checking to see if he had a job. What happened?

Music

Alex Blumberg: To help explain out what happened, here's my partner for this hour, Adam Davidson, the international business reporter for NPR. Hey Adam.

Adam Davidson: Hey Alex.

Alex Blumberg: So, I guess the first thing we have to talk about is the global pool of money, right?

Adam Davidson: Right. The global pool of money. That's where our story begins. Most people don't think about it but there's this huge pool of money out there, which is basically all the money the world is saving now. Insurance companies saving for a catastrophe, pension funds saving money for retirement, the central bank of England saving for whatever central banks save for. All the world's savings.

Ceyla Pazarbasioglu: It's a lot of money. It's about 70 trillion.

Adam Davidson: That is the head of capital market research at the International Monetary Fund, the place to go if you want know how much money is in the world.

Adam Davidson: How do we pronounce your name?

Ceyla Pazarbasioglu: That will take two minutes at least. It's Pazarbasioglu. Ceyla Pazarbasioglu. I'm very impressed.

Adam Davidson: And, by the way, before you finance enthusiasts start writing any letters, we do know that 70 trillion technically refers to that subset of global savings called fixed-income securities. Everyone else can just ignore what I just said. Let's put 70 trillion dollars in perspective. Do this. Think about all the money that people spend everywhere in the world. Everything you bought in the last year, all of it. Then add everything Bill Gates bought. And all the rice sold in China and that fleet of planes Boeing just sold to South Korea. All the money spent and earned in every country on earth in a year: that is LESS than 70 trillion, less than this global pool of money.

Alex Blumberg: Wow, that is a lot of money.

Adam Davidson: It is a lot of money. And that money comes with an army of very nervous men and women watching over the pool of money: investment managers. This army is nervous because they don't want to lose any of that money and they also want to make it grow bigger. But to make it grow, they have to find something to invest in. So, for most of modern history, they bought really, really safe, really boring investments: things called treasuries and municipal bonds. Boring things. But then, right before our story starts, something changed, something happened to that global pool of money.

Ceyla Pazarbasioglu: This number doubled since 2000. In 2000 this was about 36 trillion dollars.

Adam Davidson: So, it took several hundred years for the world to get to 36 trillion. Then, in six years, to get another 36 trillion.

Ceyla Pazarbasioglu: Yeah. There has been a very sharp increase.

Adam Davidson: How's the world get twice as much money to invest? Lots of things happened, but the main headline is all sorts of poor countries became kind of rich making TVs and selling us oil: China, India, Abu Dhabi, Saudi Arabia. Made a lot of money and banked it. China, for example, has over a trillion dollars in its central bank, and there are office buildings in Beijing filled with math geniuses-real math geniuses-looking for a place to invest it. And the world was not ready for all this money. There's twice as much money looking for investments, but there are not twice as many good investments. So, that global army of investment managers was hungrier and twitchier than ever before. They all wanted the same thing: a nice low-risk investment that paid some return.

But then something happened to make matters worse, at this precise moment, one guy took one of that army's favorite investments and made it a lot less attractive.

Alex Blumberg: So, this is where we have to talk about Alan Greenspan, right?

Adam Davidson: We have to.

Alex Blumberg: Alright. But I'm going to promise the people here that this is the last time you're going to hear Alan Greenspan in this story. So bear with us.

Adam Davidson: Here is one of his speeches that really drove that army of investment managers crazy.

> Alan Greenspan: The FOMC stands prepared to maintain a highly accommodative stance of policy for as long as needed to promote satisfactory economic performance.

Adam Davidson: You might not believe me, but that little statement: that is Central Banker speak for "Hey, global pool of money - screw you."

Alex Blumberg: Come on, that's not what he said

Adam Davidson: It is! I speak central banker and that's what he's saying.

What he's technically saying is he's going to keep the Fed Funds rate at the absurdly low level of one percent. It tells every investor in the world: you are not going to make any money at all on US treasury bonds for a very long time. Go somewhere else. We can't help you.

And so the global pool of money looked around for some low-risk, high-return investment. And among the many things they put their money into, there was one thing they fell in love with. To get it, they called Wall Street - a guy like this:

> Mike Francis: My name is Mike Francis. During the beginning of the mortgage implosion, I was an executive director at Morgan Stanley on the residential mortgage trading desk.

Adam Davidson: Mike was one link in a chain that connected the global pool of money to its new favorite investment, these residential mortgages, the US housing market, and guys like Clarence Nathan.

Think how attractive a mortgage loan is to that 70 trillion dollar pool of money. Remember, they're desperate to get any kind of interest return. They want to beat that miserable 1 percent interest Greenspan is offering them.

And here are these homeowners, they're paying 5, 7, 9 percent to borrow money from some bank. So what if the global pool could get in on that action?

There are problems. Individual mortgages are too big a hassle for the global pool of money. They don't wanna get mixed up with actual people and their catastrophic health problems or debilitating divorces, and all the reasons which might stop them from paying their mortgages.

So what Mike and his peers on Wall Street did, was to figure out how to give the global pool of money all the benefits of a mortgage – basically higher yield - without the hassle or the risk.

So picture the whole chain. You have Clarence. He gets a mortgage from a broker. The broker sells the mortgage to a small bank, the small bank sells the mortgage to a guy like Mike at a big investment firm on Wall Street.

Then Mike takes a few thousand mortgages he’s bought this way, he puts them in one big pile. Now he’s got thousands of mortgage checks coming to him every month. It’s a huge monthly stream of money, which is expected to come in for the next thirty years, the life of a mortgage.

And he then sells shares of that monthly income to investors. Those shares are called mortgage backed securities. And the 70 trillion dollar global pool of money loved them.

> Mike Francis: it was unbelievable. We almost couldn’t produce enough to keep the appetite of the investors happy. More people wanted bonds than we could actually produce. That was our difficult task, was trying to produce enough. They would call and ask “Do you have any more fixed rate? What have you got? What’s coming?” From our standpoint it's like, there's a guy out there with a lot of money. We gotta find a way to be his sole provider of bonds to fill his appetite. And his appetite’s massive.

Alex Blumberg: The problem was, to make a mortgage backed security, you needed mortgages, lots of them. So for Mike Francis to satisfy his demand, and take his quite hefty fee from the global pool of money, he needed to buy up as many mortgage pools as possible.

And to do that, he called a guy one link below him, on the mortgage backed security chain, a guy named Mike Garner, who worked at the largest private mortgage bank in Nevada, called Silver State Mortgage. And to give you a sense of how fast this business was growing, Mike got into the mortgage business straight from his previous job as a bartender.

> Mike Garner: One of my regulars in the bar, he actually hired me from the bar. He said he needed some guys, and we started talking about how much I made. He beat what I was making. I didn’t know anything about the mortgage business. I was as green as you could be.

Alex Blumberg: Mike Garner’s job was to buy up individual mortgages, mainly from brokers, bundle two or three hundred of them together, and sell them up the chain to wall street, to guys like Mike Francis.

Adam Davidson: Too many Mikes here.

Alex Blumberg: So many Mikes. Actually just two. Mike Francis on Wall Street and Mike Garner, the guy we're talking about now.

Adam Davidson: He's in Nevada.

Alex Blumberg: And in the beginning, he'd only buy mortgages that were pretty standard and pretty safe. Mortgages where people had come up with a down payment and proven they had a steady income and money in the bank.

And they sold so many mortgages that there came a point in 2003 where just about everybody who wanted a mortgage and was qualified to get one .... had gotten one.

But the pool of money had just gotten started. They wanted more mortgage backed securities.

So Wall Street had to find more people to take out mortgages. Which meant lending to people who never would've qualified before.

And so Mike noticed that every month, the guidelines were getting a little looser. Something called a stated income, verified asset loan came out, which meant you didn't have to provide paycheck stubs and w-2 forms, as they had in the past. You could simply state your income, as long as you showed that you had money in the bank.

> Mike Garner: The next guideline lower is just stated income, stated assets. Then you state what you make and state what's in your bank account. They call and make sure you work where you say you work. Then an accountant has to say for your field it is possible to make what you said you make. But they don't say what you make, just say it's possible that they could make that.
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> Alex Blumberg: It's just so funny that instead of just asking people to prove what they make there's this theater in place of you have to find an accountant sitting right in front of me who could very easily provide a W2, but we're not asking for a W2 form, but we do want this accountant to say yeah, what they're saying is plausible in some universe.
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> Mike Garner: Yeah, and loan officers would have an accountant they could call up and say "Can you write a statement saying a truck driver can make this much money?" Then the next one, came along, and it was no income, verified assets. So you don't have to tell the people what you do for a living. You don't have to tell the people what you do for work. All you have to do is state you have a certain amount of money in your bank account. And then, the next one, is just no income, no asset. You don't have to state anything. Just have to have a credit score and a pulse.

Alex Blumberg: Actually that pulse thing. Also optional. Like the case in Ohio where 23 dead people were approved for mortgages.

Adam Davidson: An interesting fact, here. Mike Garner's bank did not care how risky these mortgages were. This was the new era: banks didn't have to hold on to these mortgages for 30 years. They didn't have to wait and see if they'd be paid back. Bank's like Garner's just owned them for a month or two and then sold them on to Wall Street. Wall Street would sell them on to the global pool of money.

Alex Blumberg: Which is how we get half-million dollar, no income, no asset loans.

Adam Davidson: And loans to dead people. So there's another thing going on: housing prices were rising, fast. Lots of people in the mortgage industry had this faith that housing prices, in the US, simply never go down. So, from the bank's perspective, even if the worst happens and someone defaults, the bank would then own the house which is now worth even more than when they gave out the loan.

So, All Mike cared about was whether or not his customers--the Wall Street investment banks--would buy those mortgages from him. And he was under pressure to approve more and more loans. Because other guys in his company--the actual guys cruising strip malls all across Nevada buying mortgages from brokers, their commission depended on selling more loans. And occasionally, those guys would hear about some loan that some other mortgage company offered that they weren't allowed to offer. And they'd complain to Mike.

> Mike Garner: Three of them would show up at your door first thing in the morning and say, I lost 10 deals last week to Meritius bank. They've got this loan. Look at the guidelines for this loan. Is there any way we can do this? We're losing deals left and right. I'd get on the phone and start calling all these street firms or Countrywide and say "Would you buy this loan?" Finally, you'd find out who was buying them.
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> Alex Blumberg: So, Merrill Lynch would say no. And Goldman Sachs would say no. And you'd finally hit on somebody and they be like "Yeah, we'll buy that loan."
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> Mike Garner: Yeah, and once I got a hit, I'd call back and say, "Hey, Bear Stearns is buying this loan. I'd like to give you the opportunity to buy it too." Once one person buys them, all the rest of them follow suit.
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> Music
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> Alex Blumberg: So, what were you thinking when you're turning around and selling those to Wall Street. Were you ever thinking, "What are you guys doing?"
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> Mike Garner: Yeah. And my boss was in the business for 25 years. He hated those loans. He hated them and used to rant and say, "It makes me sick to my stomach the kind of loans that we do." He fought the owners and sales force tooth and neck about these guidelines. He got same answer. Nope, other people are offering it. We're going to offer them too. We're going to get more market share this way. House prices are booming, everything's gonna be good. And ... the company was just rolling in the cash. The owners and the production staff were just raking it in.

Tape – Glen Pizzolorusso: At the height I was making between 75 and 100 grand a month.

Alex Blumberg: This is Glen Pizzolorusso, who was an area sales manager at an outfit called WMC mortgage in upstate New York. Just to repeat, he was making 75 to a 100 grand a month. That's over a million dollars a year. Glen was just out of college. His job was a lot like Mike Garner's, he was the same link in the chain, and Glen loved his job.

Glen Pizzolorusso: What is that movie? Boiler Room? That's what it's like. I mean, it's the cooling thing ever. Cubicle, cubicle, cubicle for 150,000 sq. ft. The ceilings were probably 25 or 30 feet high. The elevator had a big graffiti painting. Big open space. And it was awesome. We lived mortgage. That's all we did. This deal, that deal. How we gonna get it funded? What's the problem with this one? That's all everyone's talking about.

Alex Blumberg: And when Glen wasn't working, he was doing his next favorite thing, spending ... preferably in the company of, and this is his term, b-list celebrities:

Glen Pizzolorusso: We rolled up to Marquee at midnight with a line, 500 people deep out front. Walk right up to the door: Give me my table. Sitting next to Tara Reid and a couple of her friends. Christina Aguilera was doing some, I'm-Christina-Aguilera-and-I'm-gonna-get-up-and-sing kind of thing. Who else was there? Cuba Gooding and that kid from Filthy Rich: Cattle Drive. What was that kids name? Fabian Barabia? We ordered 3, 4 bottles of Cristal at $1000 per bottle. They bring it out, you know hey're walking through the crowd, they're holding the bottles over their heads. There's fire crackers , sparklers. You know, the little cocktail waitresses. You know so you order 3 or 4 bottles of those and they're walking through the crowd and everyone's like: Whoa, who's the cool guys? We were the cool guys. They gave me the black card with my name on it. There's probably 10 in existence. You know? And that meant that I spent way too much money there.

Alex Blumberg: Glen had five cars, a 1.5 million dollar vacation house in Connecticut, and penthouse that he rented in Manhattan. And he made all this money making very large loans to very poor people with bad credit.

Glen Pizzolorusso: We looked at loans. These people didn't have a pot to piss in. They can barely make a car payment and we're giving them a 300, 400 thousand dollar house.

Alex Blumberg: But Glen didn't worry about whether the loans were good. That's someone else's problem. And this way of thinking thrived at every step of this mortgage security chain. A guy like Mike Francis, from Morgan Stanley, he told me he bought loans, lots of loans, from Glen's company, and he knew in his gut they were bad loans. Like these NINA loans.

> Mike Francis: No income no asset loans. That's a liar's loan. We are telling you to lie to us. We're hoping you don't lie. Tell us what you make, tell us what you have in the bank, but we won't verify? We're setting you up to lie. Something about that feels very wrong. It felt wrong way back when and I wish we had never done it. Unfortunately, what happened ... we did it because everyone else was doing it.

Alex Blumberg: It's easy to ignore your gut fear when you are making a fortune in commissions. But Mike had other help in rationalizing what he was doing. Technological help. Mike sat at a desk with six computer screens, connected to millions of dollars worth of fancy analytic software designed by brilliant Ivy league math geniuses hired by his firm, which analyzed all the loans in all the pools that he bought and then sold. And the software, the data ... didn't seem worried at all:

> Mike Francis: All the data that we had to review, to look at, on loans in production that were years old, was positive. They performed very well. All those factors, when you look at the pieces and parts. A 90% NINA loan from 3 years ago is performing amazingly well. Has a little bit of risk. Instead of defaulting 1.5% of the time it defaults at 3.5% of the time. That's not so bad. If I'm an investor buying that, if I get a little bit of return, I'm fine.

Adam Davidson: Wait Alex. I want to step in for a moment because this is a very important piece of tape. A big part of this story, of this whole crisis, is that a lot of really smart people, people who knew better, fooled themselves with this data. It was the triumph of data over common sense. Can you play that tape again?

> Mike Francis: All the data that we had to review to look at, on loans in production, that were years old, was positive.

Adam Davidson: As we now know, they were using the wrong data. They looked at the recent history of mortgages and saw that foreclosure rate is generally below 2 percent. So they figured, absolute worst-case scenario, the foreclosure rate may go to 8 or 10 or 12 percent. But the problem with is there were all these new kinds of mortgages, given out to people who never would have gotten them before. So the historical data was irrelevant. Some mortgage pools, today, are expected to go beyond 50 percent foreclosure rates.

> Music

Alex Blumberg: To be fair, they knew there were risks. But investors have a system to assess those risks. They're these special companies. Credit rating agencies. Moody's, Standard & Poor's, Fitch. Their job, their main job, is to assess risk for Wall Street and the global pool of money. They rate every kind of bond according to its risk. Triple A is the safest, then there's double A, single A, all the way down to single B and below.

And that’s all most investors look at - the letter grade. They trust the credit rating agencies. And these agencies blessed most of these mortgage-backed securities. Gave them AAA ratings - which means they were considered as safe as a US government bond.

This was the magic of this whole system. You could take a pool of thousands of risky mortgages, and create a security that was called money-good, as safe as any investment out there. At least that's what people thought.

But now we know those agencies relied on the wrong data. That same historic data that had nothing to do with these new kinds of mortgages.

Adam Davidson: And then things got even worse. The thing that took this problem and turned it into a crisis was something else that was new, something called a Collateralized Debt Obligation. A CDO. And that brings us back to the guy we met at the awards dinner in the beginning, Jim Finkel.

> Jim Finkel: We’re heading to the trading floor of Dynamic Credit, where we have all of our mortgage analysts, our head trader, our CIO.

Adam Davidson: Jim Finkel runs this CDO shop, Dynamic Credit. It takes up three modified apartments on the upper East Side of Manhattan. The trading room is like a factory floor for CDOs, it’s where they make the things. And this is what it sounds like:

> ROOM TONE.

Adam Davidson: Maybe factory is the wrong term. But this is where he makes CDOs. But what is a CDO? He shows us on a computer screen.

> Jim Finkel: Here’s our deal Monterey...

Adam Davidson: To start with, every CDO has its own name. Finkel loves his country house in the Berkshires, so he always names his CDOs after towns in western Mass. Like Monterey.

> Jim Finkel: Monterey CDO limited. 189 assets...189 tranches of different MB pools

Alex Blumberg: Let’s translate some of that. A mortgage-backed security, you remember, is a pool of thousands of different mortgages. These are all put together and divided into different slices. Jim used the word tranche. Tranche is just French for slice - some of these slices are risky, some are not. OK, a CDO is a pool of those tranches. A pool of pools.

And Jim and most companies like his weren’t buying the top-rated tranches - the safest ones, the AAAs. They were buying the lower-rated stuff. The high-risk stuff. Jim’s company was buying tranches that came from Glen Pizzolorusso’s company. The guy who hung out at nightclubs with B-list celebrities. The guy who said he was selling mortgages to people who didn’t have a pot to piss in.

Adam Davidson: There's another term the industry uses, no joke, they call these lower-rated tranches toxic waste. They're so high-risk, they're toxic.

Alex Blumberg: So, a CDO is sort of a financial alchemy. Jim takes that toxic stuff, these low-rated, high-risk tranches, puts them all together. Re-tranches them, and presto: he has a CDO whose top tranche is rated AAA, rock-solid, good as money.

If this seems too good to be true to you, you're in good company. Guys like billionaire investor Warren Buffet said the very logic was ridiculous. But back in 2005, 2006, the global pool of money couldn't get enough of these things.

And the CDO industry was facing the same pressures everyone else was at every other step of this chain. To loosen their standards. To make CDOs out of lower and lower rated pools. This is Jim's partner, Tonko Gast.

> Tonko Gast: In 2005, we had an internal debate here because there were two banks coming to us, why don’t you do a deal with us, BBB securities, you get paid a million bucks in management fees per year. Very clear, just like that, in 2005. And we declined those deals. We just don't believe those BBB RMBS assets are money-good. And we thought if we do a CDO of those, that's gonna blow up completely. We were early in '05 by not wanting to do those deals. People were laughing at us. Saying you're crazy. You’re hurting your business. Why don’t you want to make ... Per deal, you could make a million dollars a year.
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> Adam Davidson: Did someone do that deal?
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> Tonko Gast: Absolutely! Everybody. Not everybody, but a lot of people did.

Ira Glass: Coming up, how 5 million dollars can get you into 100 million dollars of trouble. In a minute, from Chicago Public Radio and Public Radio International, when our program continues.

ID BREAK

Ira Glass: Well it’s This American Life. I’m Ira Glass. And although I feel fine, I have lost my voice this week. Today’s show, a special co-production with NPR news. A step-by-step look at what exactly happened during the sub-prime mortgage crisis. One of our producers Alex Blumberg co-reported this story with NPR reporter Adam Davidson. The story continues.

Alex Blumberg: From 2003 to 2006, the housing market was in a classic speculative bubble. Home loans were easy to get, so more and more people were buying houses. The increased demand for houses caused the price to increase. The rising prices created even more demand, as people started to look at homes as investments -- investments that never went down in value. In 2003 and 2004, 2005, they didn't. You could buy a house with no money down, turn around and sell it a year later for in some areas double what you paid. People who'd never invested in real estate before started buying multiple properties as investments. There were shows on TV about how to do it. Here's a promo.

Tape: Promo from "FLIP THIS HOUSE" with song.

Alex Blumberg: This is A&E's "Flip this House," Discovery had the cleverly titled "Flip That House." There were other ones. "Property Ladder," "Design to Sell." Bravo came late to the game, debuting their show, "Flipping Out," in November of 2007, well after the bubble popped.

Tape: more promo

Alex Blumberg: The problem was that even though housing prices were going through the roof, people weren't making any more money. From 2000 to 2007, the median household income stayed flat. And so the more prices rose, the more tenuous the whole thing became. No matter how lax lending standards got, no matter how many exotic mortgage products were created to shoehorn people into homes they couldn't possibly afford, no matter what the mortgage machine tried, the people just couldn't swing it. By late 2006, the average home cost nearly four times what the average family made. Historically it was between two and three times. And mortgage lenders noticed something that they'd almost never seen before. People would close on a house, sign all the mortgage papers, and then default on their very first payment. No loss of a job, no medical emergency, they were underwater before they even started. And although no one could really hear it, that was probably the moment when one of the biggest speculative bubbles in American history popped.

Strangely, the first people in the mortgage-backed security chain who noticed, were the ones near the top. The people on Wall Street, like Mike Francis. He can remember almost to the day:

Mike Francis: It would be somewhere around Halloween of 2006. We started seeing our securities that were 6, 7, 8 months old start to perform poorly. We started to dig into the details. Wow, property values stopped increasing. Something is turning around bad here. What do we do?

Alex Blumberg: The problem was that once property values starting going down, it set off a reverse chain reaction, the opposite of what had been happening in the bubble. As more people defaulted, more houses came on the market. With no buyers, prices went even further down, and as prices declined, Mike Francis cleared up a mystery. Remember, even though he didn't trust these NINA loans, the bonds that he turned them into, they performed well. Well, there was a reason.

Mike Francis: it's obvious that they performed well, now, because their property kept increasing in value. Over time, they could take cash out to pay the bill.

Alex Blumberg: In other words, they could take out another loan from the bank, against the value of their house, which because of the bubble, was now worth more than they bought it for. These loans, called home equity lines of credit, became very popular in the early to mid 2000's. Partly because they were easy to get. But partly because people needed them to continue making their original mortgage payments. To pay off their debts, they went into more debt.

And in late 2006, early 2007, as prices began their plunge and alarm was spreading across mortgage backed securities desks all over Wall Street, the people on Wall Street, like Mike Francis, started backing away from some of the riskiest mortgages that they would accept in their pools. Which had a devastating effect on the mortgage companies, which had proliferated to sell them loans, a devastating effect on people like Mike Garner, the mortgage banker in Nevada. For one simple reason.

> Mike Garner: All these mid-sized companies like us, we're not using our own money to fund these loans.

Alex Blumberg: The way it worked was that a small bank, like Silver State mortgage, where Mike Garner worked, would borrow money from a big bank, say Citibank, or Washington Mutual. Silver State would use this borrowed money to buy up a bunch of loans, and then pay back the big bank once it sold the pools to Wall Street. Now these smaller banks were highly leveraged, in most cases 20 to 1. Meaning, in Silver state's case, even though it only had 5 million of its own dollars, it could borrow 20 times that, 100 million, to buy loans with. So in late 2006, Mike is busily at it, borrowing, buying, selling, paying back, and borrowing again, when the e-mails started coming:

> Mike Garner: We'd get an e-mail from a street firm, just say Credit Suisse/First Boston. It'd say, after whatever date, "As of December 29th, we are no longer buying Stated Income with a FICO less than whatever." It'd say "There will be no exceptions. Pleas do not call the pricing desk." And you just start flipping out. Can't just say you're not going to buy this with no notice. Well, we're saying it and there's no notice. Then you start to scramble trying to get this stuff out of the door as soon as you can.
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> Alex Blumberg: Because you've already been assembling a bunch of those loans with those characteristics in place somewhere.
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> Mike Garner: You've got 20 million sitting there, and you say oh crap, I better get those out the door. Within a week, you can expect to see the same email from all them. A lot of time you'll get two of those the same day. You're scrambling to sell them, going off sheer relationships. Like okay, I've still got 10 million of these. I know you're not buying them anymore. But come on ... you can't just leave me like this. There comes a point where all of them said, we're not buying anything.

Alex Blumberg: For Mike and his company, that meant that they'd borrowed tens of millions of dollars to buy loans, that now, they couldn't sell. And since they had very little of their own money, (just like the homebuyers whose mortgages they'd purchased) they had no choice but to default on their loan. Silver State Mortgage's nearly 600 employees were out of work. Quite suddenly.

Mike Garner: It was February 14th the email went out and said "Silver State Mortgage might be going out of business, but we think we can work something out so we'd encourage you to come in and work tomorrow and give us one more day." The next day, people came in and the e-mail went out. "Unfortunately we were not able to work anything out. We're closing our doors today." That's how most of these lenders go under. Everybody's working thinking everything's great. Chugging along. All of the sudden, the bank says you're done. People started grabbing their computers, copy machines, started rolling them out the door. It was a mess. My thoughts were "Holy crap. Everyone's just stealing their stuff."

Alex Blumberg: That happened on Feb. 14th?

Mike Garner: Yup. My boss calls it the valentine's day massacre."

Music

Alex Blumberg: For Glen Pizzolorusso, the mortgage sales manager who - not to dwell on this detail - was living the live of a B-list celebrity, the end came more slowly.

Alex Blumberg: So you're at WMC, what was the turning point?

Glen Pizzolorusso: This sounds obscene, but it was first month I got a $25,000 paycheck. That didn't even cover my expenses." So you're sitting here and you're like I made 25,000 this month, which is more than most people make in six months and that doesn't cover my expenses. Now what do I do? The next couple months I made 30 or 40 grand, then it went down to 10. You could just feel it winding down. The good old days were over. It was scary.

Alex Blumberg: So give me your situation now. Can you pay all your bills now?

Glen Pizzolorusso: Not really. I borrowed some money from friends...from dad. Living in my house right now, we're working with the bank to try to avoid foreclosure. At this point I'm dealing with an attorney. Trying to figure out if it just makes sense for me to walk away from the house.

Alex Blumberg: And have you made mortgage payments?

Glen Pizzolorusso: No. No.

Alex Blumberg: When was last time you paid your mortgage?

Glen Pizzolorusso: January? I've been making em spotty, as I can. Just enough to keep them off my back. I have to watch every penny.

Richard Campbell: As you can see this is my living room, I have no furniture. And it's either buy furniture or pay my mortgage.

Adam Davidson: This brings us back to Richard, the Marine we met at the very top of the show. He, like more than 4 million Americans, at this point, is fighting to keep his home. He's giving me a tour.

And I wanted to talk to him about what now? What happens next? Now that the housing bubble has turned into a nationwide crisis.

If he defaults on his mortgage, nobody wins. He doesn't want to leave his house, and the investors who own his mortgage, the last thing they want is to own a house in East Flatbush, in a declining market with no buyers.

So you think it'd be easy for both sides to modify Richard's mortgage, do something he can afford. You'd be wrong.

Kerry Campbell: Hi I'm Kerry Campbell nice to meet you...

Adam Davidson: The offices of NACA, the Neighborhood Assistance Corporation of America, in Newark, New Jersey, are short on frills. Kerry Campbell, who's helping Richard today, is a counselor here.

The goal today is to figure out how big a mortgage payment Richard can actually afford to pay. So, Kerry needs to know everything Richard spends money on. They go through his medical bills, his clothing budget. Kerry gently nudges Richard to be realistic. Like when he asks Richard how much he spends on gifts for his family.

Kerry Campbell: Gifts to family? How much would you say on average?

Richard Campbell: 300, Christmas time?

Kerry Campbell: January through December. Mother's day. Father's day. Sisters brothers. Nephews, nieces? Significant other. If you celebrate Christmas. Whole enchilada.

Richard Campbell: Around $1000.

Kerry Campbell: That sounds about right.

Adam Davidson: The process now, how does it compare to when you bought the house?

Richard Campbell: This is totally different. Brand new to me. When I bought the house, it was just your credit score and can I pull a credit report?

> Adam Davidson: So in this whole process, when's the first time someone looked at your finances?
>
> Richard Campbell: Today. Today.
>
> Music

Adam Davidson: Not to say the original broker didn't have a process. It just had nothing to do with reality. Kerry shows Richard the original loan documents, filled out by his broker.

> Kerry Campbell: Here it's saying your base employment income is 16,250 a month.
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> Richard Campbell: Laughs. Wha?!
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> Kerry Campbell: That means your salary, on a yearly basis, would be $195,000 to be exact.
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> Richard Campbell: I wish. In 2005, right, and they used my 2005 taxes, I was making $37,000 that year.
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> Adam Davidson: Did you know that number until now?
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> Richard Campbell: no
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> Adam Davidson: To me, that is shocking. It's not shocking to you?
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> Kerry Campbell: That's outrageous. But it's a common thing. It's worlds apart, reality and what's on these documents.

Adam Davidson: Another thing the papers reveal: How much that creative broker made. $18,500 dollars. As Kerry says, that's 18,000 reasons to falsify Richard's mortgage documents and to put him in a house he can't afford. Richard actually qualified for a Veterans Administration loan at a really good rate, and he had money to put down, but the broker convinced him to take a mortgage that turned out to be much worse, with a much higher commission.

Mortgage brokers were walking around East Flatbush, knocking on doors, telling just about anybody: Hey, we can get you a house. If you have a house, we can get you a big home equity line of credit. This happened in poor neighborhoods all over the country. And, while the FBI and other law enforcement folks, say they don't have the exact numbers, it's clear that fraud--like the fraud on Richard's application--was ubiquitous.

At the end of Richard's budget process, the math they come up with is fairly stark. Richard makes more money now--he got a new and better job, so he makes an average, before taxes, of 8,000 dollars a month. Which means, after taxes, he brings home exactly enough to pay his mortgage and nothing else. All of his living expenses, he says, are paid with money he gets from his mom who is on public assistance, his girlfriend, and his brother.

Kerry runs his software which says that if Richard is going to stay in his house, he needs a much cheaper mortgage. The interest, currently at around 10%, would have to be lowered a lot. To 3%. Kerry wants to propose this to whoever own loans the loan. But this brings him to this peculiar problem mortgage owners now face: they have no idea who that is. Richard's loan has been bought and sold, and re-sold and put into one of those pools, owned by investors. Maybe an investor like Jim Finkel.

> Jim Finkel: You know, 150 times, what did we say? 3000.

Alex Blumberg: So now we’re back in Jim Finkel's office. He's surrounded by expensive computers, but he's typing on a cheap calculator. And he's trying to figure out for us how many individual mortgages--how many homes like Richard's--does he own part of. The calculator method fails him, and he turns to one of his number crunchers, a guy named Alex.

> Jim Finkel: I can't even imagine. Alex do you have any idea...

Alex Blumberg: Alex gets on the phone with Steve--the IT guy.

> Alex: How many loans are you running in that loan performance? All together? For all of our deals ... 16 million loans.

Alex Blumberg: This one CDO factory--this one office, owns a share of 16 million homes. And each of those homes has lots of other owners--people in other CDO offices around the world--there are lots of them. And other investors. You start to see what a crazy web of confusing interconnections this whole process is.

Now, until this moment we had a theory that these two groups--the homeowners and the people at the top of the chain, the investors--had no idea about each other. We actually learned they know quite a lot about each other. They just see each other through a computer screen.

> TAPE: Hey Steve.

Adam Davidson: We find that out when we go downstairs to see Steve Pennington, the IT guy. Steve’s actual title is the head of financial engineering. He's created his own software program that actually looks at every one of the 16 million loans Dynamic owns part of. It's a spreadsheet. Each line is one loan. It says how much the house sold for, what the interest rate is. He points to one field--the most baffling one--that is just twelve letters and numbers in a row. Every letter represents a month.

> Adam Davidson: What does the 9 mean?

Steve Pennington: It means they’re 90 days, basically delinquent on their loan.

Adam Davidson: Is this the matrix? Where the guy is looking at the green digits, and says there's the redhead and the blonde. Are you, Steve, seeing lives here?

Steve Pennington: I definitely see lives.

Adam Davidson: For the record, I see cccc36c36. I do not see a human drama.

Steve Pennington: The drama here is you have someone paying their loan, then something happened. They’ve gone 3 months, delinquent...They got to this point of 6, then fought back to current.

Adam Davidson: Now that I've learned the code, I see it. Like here, he was on time for a bunch of months. This one, he was on time, 30 days, 30 days, then he went two months behind, came back. And now he's just behind.

Steve Pennington: And what’s really hard about this, is you can watch people cycle on and off.

Adam Davidson: You guys are more sympathetic. And maybe it’s just cuz we’re reporters and you want to make us think you’re good guys –

Tonko Gast: We’re human beings

Adam Davidson: But these guys are hurting you. Their irresponsibility is costing you money and work.

Tonko Gast: That was up to us to think about 3 years ago.

Adam Davidson: Do you have any anger when you look at this?

Tonko Gast: Not at all. This is pure sadness.

Alex Blumberg: This is where the partnership of borrowers like Clarence Nathan and investors like Jim Finkel has ended up.

Tonko Gast estimates that most of AAA rated mortgage-backed CDO's that the industry created since 2006, are now worth less than half their value. Some are worth close to zero. But remember to all the investment managers in the global pool of money who bought them, AAA meant safe as government bonds. AAA was called a cash equivalent, money in the bank. It's as if the global pool of money put trillions of dollars in a savings account, came back one year later, and found out that half was gone. Put another way, it's as if the global pool of money thought it was putting trillions of dollars in a savings account, but really, half of it was going into a furnace. The money is gone, burned up, never to come back.

And that's what's led to the new term you've been hearing.

Adam Davidson: Maybe you've noticed that the press and others don't call it a sub prime housing crisis as much anymore. They call it a credit crisis. The global pool of money still has no idea how much money they lost. How much went into the furnace. And because of that, they’ve totally changed their thinking. They used to be obsessed just with getting some profit, trying to make a slightly higher interest rate return. Now the global pool of money has the exact opposite obsession. It wants no risk whatsoever. It just wants safety. Suddenly, those US government treasury bonds--still near historic lows of 1 and 2 percent--are beautifully attractive. Because they're safe. They won't blow up like sub-prime CDOs did.

The global pool of money is avoiding anything with even the slightest hint of risk and that affects everybody, no matter who you are. It's harder to borrow money to buy a house, or build a factory, or bring your country boldly into the 21st century. Take Iceland. A year ago it was easy for them to borrow billions. Now, they're seen as too risky. Their central bank has to pay more than 15 percent interest get anyone to loan them money. They could do better putting their national debt on a credit card. Hungary, Kazakhstan, Turkey, are all in similar situations. You might have heard about problems in student lending. Companies that needed credit to survive are shutting down. The US expects more than 1.1 million bankruptcies this year: twice the 2006 number.

This freezing of credit all around the world is something new, the world has never seen anything on this scale. When the crisis hit, last August, central bankers and finance economists couldn't figure out how bad things might get. There was this question people would ask: will things get like the 1930s or the 1970s? There was real fear that, just like in the '30s, hundreds of banks would collapse, there would be massive unemployment, there was talk of a new Great Depression.

Alex Blumberg: That talk seems to have faded and there's more talk that the next few years will feel like the 1970s. There are lots of technical differences between this crisis and Jimmy Carter's malaise. But for the average person, it could feel the same. It's not an out-and-out depression. Everything's just kind of crappy. And not just in housing or banking but for the economy as a whole. It’s barely growing. There aren't a lot of new businesses, new jobs. Unemployment keeps creeping up. We're just sort of stuck, in neutral, for a while.

Anyone under, say, 45 probably doesn't remember that 1970's malaise too well. Anyone under 30 has barely known a US economy that wasn't growing. Now there's a decent chance we'll all get to see what life felt like in the '70s. Which isn't great. It's pretty bad, actually. Unless you're comparing it to the 1930’s.

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