This American Life Episode Transcript
Program #365
Another Frightening Show About the Economy

[Ambient sound of cars on city street]

Ira Glass: Well, it's *This American Life* from WBEZ Chicago, distributed by Public Radio International. And I'm recording this on Friday afternoon, October 3rd. It's a little after three o-clock, just a couple of hours after the House of Representatives voted in favor of bailing out Wall Street. And I'm standing in Union Square in New York City, maybe a, I don't know, 15-minute subway ride from Wall Street.

It's been a week and two days since President Bush declared that we're in a serious economic crisis. It's been two weeks and a day since the Chairman of the Federal Reserve reportedly told Congressional leaders that without a bailout plan, we might not have an economy. But standing here, I think maybe for most of us going about our daily lives, it doesn't feel like we're on the edge of a disaster. There are people streaming in and out of the Virgin Megastore with packages. A guy just unwrapped a cell phone that he bought in there about three feet from me. There's a huge farmers' market going in the park. So there's this disconnect. Even for people who have seen the value of their homes and their retirement plans drop, it's just hard to know what to believe about how bad things really are. And how bad they might get.

Music

Well a few months ago on our program, Alex Blumberg and NPR Economics Correspondent Adam Davidson put together an hour explaining, in terms that anybody could understand, how the sub-prime mortgage crisis happened in the first place. And after that aired we were flooded with e-mails about that show. It was all over the internet. The New York Times wrote an article about it, how helpful it was. So today we asked those guys to come back. And explain some of the things that have happened since that first show. Including, how bad are things, really? And is this bailout a good idea? It's another frightening hour about the economy. Stay with us.

Music

Ira Glass: Well hi, fellas.

Adam Davidson: Hey, Ira.

Alex Blumberg: Hey, how's it going?

Ira Glass: Well let's start with what Treasury Secretary Henry Paulson and Fed Chairman Ben Bernanke saw that made them believe that the economy is in terrible, imminent danger. You guys did a story on All Things Considered that you've expanded to play here on our program about some events that began two weeks ago. Specifically that began on Wednesday, September 17th.

Act One. The Day the Market Died.

Alex Blumberg: To give you a sense of what government officials saw that freaked them out, a lot of it probably had to do with conversations with people like Mark Peterson. Who is not on Wall Street – he's in Memphis. He has nothing to do with the sub-prime mortgage industry. And that week, two weeks ago, that had him shaken. Almost literally.

> Mark Peterson: Ah, I don't know, for those of you who have experienced an earthquake? You know some people say it's a soul wrenching experience. Because you realize there's a power out there that's doing something that you have no control over whatsoever. And it's massively moving everything. And that's last week. Last week there was a monster that was unleashed.

Alex Blumberg: Now you may be surprised to learn the name of that monster: the commercial paper market.

Adam Davidson: Technically, actually it's the *freezing* of the commercial paper market that was the monster. Let's explain what the commercial paper market is. It's a way for companies to borrow money. The easiest way, for big companies. And here's how it works. A guy like Mark Peterson, he's the treasurer, sort of the money manager, for ServiceMaster International, a company which owns, among other things, a lawn care company, Merry Maids, and Terminix, which will get rid of your termites.

Every day Mark comes in to the office at 8 in the morning and asks the same question. How much money do we have?

> Mark Peterson: Let's just say you had Terminix come out and treat your house. You write a check. When they deposit it in our account they send us the information off of that check and says this person paid their bill.
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> Alex Blumberg: And so every day, you know, thousands or hundreds of thousands or tens of thousands of Terminix customers and other people are writing checks. That data then gets sent to you on sort of a daily basis. And you sort of have the position of like what's our cash position now for the day in this company.
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> Mark Peterson: Yep. Either we're going to have too much money at the end of the day, or we're not going to have enough money at the end of the day.
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> Adam Davidson: Today, do you have money or do you need money?

Mark Peterson: Today we – today our company, we have money.

Alex Blumberg: But tomorrow, they might not. Maybe they need to buy a lot of termite poison or upgrade their fleet of termite fighting vans, for example. It's no big deal. You just borrow some more money. Every company works like this. Some days they have extra money. Some days they need to borrow extra money.

Adam Davidson: If you're a regular person and you need to borrow money, of course you probably use your credit card. If you're a gigantic company, you use the commercial paper market, which is, basically, an industrial-sized IOU.

Mark Peterson: We would say, “I'm going to give you a million dollars tomorrow, if you give me 999,000 dollars today.”

Alex Blumberg: Got it.

Mark Peterson: So tomorrow whoever sent the 999,000 dollars in, he’s going to get an extra thousand bucks tomorrow. And that’s his interest rate.

Alex Blumberg: And so every day treasurers all over America and all over the world are getting into their offices at 8. They’re surveying their data, and then they’re going and they’re issuing commercial paper… How much money are we talking about?

Mark: It's hundreds of billions of dollars.

Alex: Every day.

Mark: Every single day.

Adam Davidson: How do treasurers like Mark Peterson connect with the people who want to loan them money? They do it through banks on Wall Street.

The Treasurer of a big company – or someone on his staff, usually – calls some guy they know on Wall Street and says, “Hey, we need some money. Sell some commercial paper. Issue those IOUs.” That is the commercial paper market.

Alex Blumberg: And this happens every day. The US economy could hardly function without it. And yet almost no one has heard of it. Why?

Mark Peterson: It's been a relatively boring business. Your commercial paper desks, in many companies, it could be somebody down at almost a clerical level calling every single day to Merrill Lynch and saying, “I need to borrow 50 million. At what rate can I borrow at?” Post that rate and let's get it done by eleven o’clock in the morning. The Merrill Lynch sales people go off and sell the commercial paper to money market funds and trust departments and investors all across the world. They confirm that the money has been funded into the clerk's account, and then the clerk turns it over to the treasurer and says, "Your 50 million is here." By eleven o'clock in the morning.

Alex Blumberg: And it's just that straightforward.

Mark Peterson: It's that straightforward.

Adam Davidson: It stopped being boring some time this year, huh?

Mark Peterson: Well, as a good friend of mine who is on Wall Street made the comment – he said, "I've never seen anything like this before." He said, "There's no bid in the market for paper. There's nobody willing to transact with each other." The commercial paper market, which is the most liquid market probably in the world, for high-grade financial players, basically froze up.

Music

Paul Balika: As a person involved in the front-end, um, I don't think I've ever been this nervous in my career because I think the financial system was so close to locking up. And – I think we were real close to the abyss. The ultimate freezing of the financial system.

Adam Davidson: This is Paul Balika, another guy with a front-seat view of this credit seize-up. He works at Daiwa Securities, and Alex and I spent a lot of time with Paul, and with other traders like him, trying to get a sense of what that abyss looks like.

[Ambient sound of talking and laughing on trading floor]

Alex Blumberg: Like here – Tradition Securities. They're a commercial paper trading company in lower Manhattan, near Wall Street.

And I'm here to see a trader named Tom Corona. As I walk across the huge trading floor with my headset and microphone, traders are shouting out, teasing Tom. Asking about his new friend, which is me. He says he's doing an interview for the radio, and I hear one of his buddies mutter, "This won't end well."

Now most of the companies that Tom works with aren't consumer services companies like ServiceMaster, where Mark Peterson works. They're banks. Big huge banks that you've probably heard of. The treasurer's assistants at those big banks call Tom every day and they say, "I want to borrow some money." But since about two weeks ago, that's been almost impossible.

Tom Corona: A bank will call me up in the morning and say, "What are you seeing in the marketplace today?" And unfortunately at this point, I say, "It's the same thing I see every day. It's the banks trying to raise money, and nobody willing to lend them money. And if you needed to get money, this is the rate you would have to pay." And even if they could get money, they could only get 50 or 100 million. Now I don't mean to let 50 or 100 million sound like a little, but in our market it's nothing. It's so small. These banks, normally at that spread, could raise billions, in an eye-blink.

Alex Blumberg: And then what do they say to you?

Tom Corona: Well they're as concerned as I am… You can sense the frustration, in everybody's voice. I hear constantly on the phone now, everybody having trouble sleeping. You know, they don't see a light at the end of the tunnel. And if it is a light they see, it's another train coming at them.

Alex Blumberg: Okay, for those keeping track, this market freeze-up has been compared so far in our story to an oncoming train, an abyss, a monster and an earthquake. All we need now is a serial killer.

Adam Davidson: And what made this abyss/earthquake/train/monster materialize all of the sudden? There was one event in particular that frightened the commercial paper market and made it seize up.

Explaining it, I'm afraid, means using another finance term, although this one might be a little more familiar: the money market mutual fund.

Alex Blumberg: And we should say here, a money market mutual fund is just, it's like a savings account. There's a good chance you even have one. It is, in normal times, one of the safest places to keep your money. You put 1,000 bucks in, you know, for sure, you'll get 1,000 bucks out. Maybe even 1,010. And you're happy with just that little return because you know at least your money is secure.

Adam Davidson: Now one of the main things that money market managers do to get that little return is they lend money out on the commercial paper market. They give guys like Mark Peterson at ServiceMaster that 999,000 dollars. He gives them that million dollars back the next day. It's an okay return, but the main thing is it's safe. Their money is safe, because they're lending it to huge, trusted companies, many of which have been around for decades, reliably paying back these loans. At least that's the way it was until two weeks ago, when one of the most dreaded things happened – at least in the world of money market managers. It's the thing they have nightmares about.

Alex Blumberg: One of the biggest and oldest funds, called the Reserve Fund – that was its name. It "broke the buck." What that means is, for the first time ever, it lost its depositors' money. For every dollar they'd put in, they were left with only 97 cents. It's like going to your savings account and seeing that your money's gone, but you haven't made any withdrawals. It's a big deal.

Paul Balika: Breaking the buck is sort of like having a serial killer in a high school,

> you know. It causes a little bit of panic. Take a look at some of the returns. People are not concerned about getting a return on capital. They just want the return of capital. So that is panic. That is fear.

Adam Davidson: That panic and fear caused an old-fashioned bank run. People, and more importantly pension funds and big endowments, called their brokers and said, “Get me out of those funds.” The government had to step in and guarantee the money market funds.

Alex Blumberg: And this, right here, as near as we can tell? This is what freaked out Henry Paulson and Ben Bernanke. Because this right here is the mortgage crisis spreading out into the rest of the world. This fund that broke the buck? They weren't investing in risky mortgages, or anything related to the housing industry. They were not freewheeling Wall Street fat cats taking big risks and hoping for a windfall. They were investing in investments that those fat cats laughed at. These were fund managers doing everything possible to be totally safe, doing what they always did: buying very safe, very short-term commercial paper. It just so happened that the company they bought it from was Lehman Brothers. And the day before, Lehman had gone bankrupt, in part because of *its* exposure to risky mortgage products. So all the money this money market mutual fund, The Reserve Fund, had lent to Lehman was suddenly gone. And the Reserve Fund, a mutual fund that had nothing at all to do with mortgages or the housing market, was all of the sudden in trouble.

Adam Davidson: That’s what caused the panic. All the other money market mutual fund managers freaked out. They wondered, “Who's going to be next?” And then, like a horror movie – at least a horror movie made for money market mutual fund managers – another fund broke the buck. And then AIG, the largest insurance company in the world, nearly collapsed.

That was it. Money fund managers decided, “We're not lending any more money out to companies at all.” That Wednesday and Thursday, over $100 billion flowed out of the commercial paper market. Most of it went into treasury bills – government securities.

Alex Blumberg: And that's why Tom Corona, the commercial paper trader, can't get any money for his clients. The people who used to lend it to them have hunkered down, and stashed it in what amounts to the largest mattress in the world, the US government. Their perception is, that's the only safe place to be right now.

> Tom Corona: Perception, in this market… In the financial markets, perception is everything. They don’t know who has losses and who doesn’t have losses and who really is hiding losses, who has revealed all their losses. Nobody trusts each other any more. So that money funds look at each bank and everybody looks with a wary eye because they don’t know who’s in solid footing.

Adam Davidson: Ben Bernanke and Henry Paulson are afraid that this situation could spread even further. It won't just be money market mutual funds who won't want to lend money. Nobody will want to lend money. Here's Paul Balika.

> Paul Balika: What would happen is that no one would be able to borrow money. And then how does capitalism work if you can't borrow money? You're back to bartering, pretty much, you know. You know, no working capital. The extension of credit just almost came to a halt. Just ended, period. I don't mean to be histrionic, but from my perspective if Paulson and the government didn't step in with this plan, the banks would not be able to create enough credit to make the economy function. That's all.
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> Mark Peterson: The stakes are this…

Alex Blumberg: Again, Mark Peterson, at Servicemaster International. He says imagine a company that wants to build a new factory.

> Mark Peterson: Normally they would just borrow it and then pay it back over a period of time. But if they have to now wait five years before they have enough capital to build that plant, they'll delay that. You know, you might sit back in your little – you know, here in Memphis, and say that that doesn't really affect you. But if 20,000 treasurers and CFOs throughout the world are having that problem collectively because their banks are all frozen? What you've got is something that will affect every single person in America, ultimately.

Alex Blumberg: And right now this is starting to happen. Every day there is news of companies canceling plans because they can't get loans. There were reports that McDonald's had to postpone a plan to get latte machines in its stores because it couldn't borrow the money. The company that makes Thomas the Tank Engine toys? Had to cancel a merger. And General Electric – General Electric, the second largest US company, owner of NBC and maker of aircraft engines and nuclear power plants – saw its stock fall nearly 10% because of concerns that it couldn't borrow the money it needed to continue to function.

Adam Davidson: Now we should say, Alex, that all of these companies deny any serious problems. And there's a lot of businesses that still seem fine. Mark Peterson of Servicemaster International says banks still lend his company money, at slightly higher rates than last year, but nothing his firm can't handle. Small businesses can still get lines of credit. People can get auto loans or mortgages or credit cards. Rates might be creeping up a bit, but walking around outside, it definitely doesn't feel like the next Great Depression.

Alex Blumberg: For most people. And that's why for most people outside the financial sector, it's hard to grasp this dire need for a $700 billion bailout package. The doomsday scenarios are scary, but will they really happen? It turns out, even if you have a seat at the epicenter of the crisis, like Tom Corona, the commercial paper trader, who's seeing first-hand how credit has frozen up for all his big clients, and who has everything to lose if the situation doesn't improve, even he has conflicted feelings about it.

Tom Corona: I'm sort of stuck between a rock and a hard place, because, you know, I'm watching the career I've chosen, and it's been very good for me, but I'm watching the whole system sort of implode. And yes, I want the bailout to save Wall Street, because this is where I work, but then I look in a bigger picture what's better for the country and for my children – I have three boys – and I do not believe this billion dollar bailout helps out my children, or anybody's children, over the long run. People made stupid loans and now they want the government to bail them out. And I'm sorry. At this point, it's my tax dollars, it's your tax dollars. I just think we have to say no.

Alex Blumberg: And did you actually call – you called your congressman?

Tom Corona: Yes. I sent all of them e-mails. My e-mail basically said I was against any sort of bailout plan. That there were other issues to deal with and that I was a 27-year Wall Street veteran in the institutional money markets, and if he would like to discuss it any further I would gladly take his call.

Alex Blumberg: Has anybody called?

Tom Corona: Nobody has called. I don't take it personally.

Music

Alex Blumberg: But to give you a sense of how fast things are changing, that tape of Tom Corona is from a week ago. And when we talked to him today, he said he does support the bailout bill now, for two reasons. There have been changes made in the law which he likes, but also, and probably more importantly, he's a lot more scared now than he was just seven days ago. This last week has convinced him that the crisis is spreading, and that the bigger risk to his children now is doing nothing.

Music

Ira Glass: Alex Blumberg, and NPR's Adam Davidson. Coming up. You want to know. We want to know. Is this Wall Street bailout good or bad? That and a whole lot more, in a minute. From Chicago Public Radio and Public Radio International, when our program continues.

It's *This American Life*. I'm Ira Glass. Each week on our program of course we chose a theme, bring you different kinds of stories on that theme. Today we have Another Frightening Program About the Economy. Today's show is a co-production with NPR News. Alex Blumberg and Adam Davidson return to our airwaves to explain what exactly all these complicated things that we hear about the current financial crisis really mean. And before we go any further I want to say that there is so much happening each day in the financial news that Alex and Adam and some colleagues at NPR have started a daily podcast explaining all this stuff. It's called the Planet Money podcast.

You can find it by googling or by going to the iTunes store. It is free. It is very, very helpful. Right now, though, we have arrived at act two of our program.

Act two. Out of the Hedges and Into the Woods.

One way that you can tell that things are bad in this country is that: you find yourself suddenly trying to understand things that you really never cared about at all. Case in point: before we invaded Iraq, be honest, did you actually know the difference between the Sunnis and the Shias? Okay, another case in point. Act one of our show today was about the commercial paper market, something I really never imagined we'd spend much time investigating on our program. Now, in act two, we have one more confusing financial product that is bringing down the global economy. And one of way to think about this product is this: if bad mortgages got the financial system sick, this next thing you're about to hear about helped spread the sickness into an epidemic. These are credit default swaps. Alex explains.

Alex Blumberg: Like many parts of the financial system these days, credit default swaps are so complicated, simple bankers couldn't have created them. They were invented by people like this guy, Gregg Berman:

> Gregg Berman: Actually my formal training is in physics. So I studied experimental physics and nuclear physics before joining finance in 1993.

Alex Blumberg: Now normally when you think of physicists inventing scary things, atomic weapons come to mind. And in fact, credit default swaps have been called, by no less an expert than billionaire Warren Buffett, financial weapons of mass destruction.

Now just to be clear, Gregg didn't actually invent these things, but he works for a company, Risk Metrics Group, which, you won't be surprised to learn, helps companies manage risk. And so he thinks about them a lot. And he's good at explaining what they are. Imagine, he says, you buy a bond from Ford, for 100 dollars:

> Gregg Berman: You're holding the bond and you are worried about Ford's credit. So you enter into an agreement with another party where you say to the other party, "I will pay you some money. I will pay you 2% a year, 3% a year, 4% a year. And what you need to do is give me protection. If Ford should go bankrupt, then I'm going to give you back this perhaps worthless bond and you're going to give me my $100 back." In big context of things, it looks like insurance. So it sort of looks like you bought an insurance contract. And you're paying a bit of a premium, as you would if you were buying fire insurance on your home.

Alex Blumberg: So... insurance? That's what we're talking about here? People with bonds, which are already considered safe and boring, trying to make them even safer and more boring? Well, let's just say it didn't stay that way.

Satyajit Das: I think Mae West once said it very, very well when she said, “I used to be Snow White, but I drifted.”

Alex Blumberg: This is Satyajit Das – he just calls himself Das – and he’s a risk consultant, who was around when credit default swaps first appeared. Adam and I talked to him and heard stories from his 30 years working with hedge funds and bankers all over the world, as a sort of financial hired gun. And he saw first-hand how what started as insurance, morphed into something else entirely.

Satyajit Das: In the 1990s and probably until about 2003-2004, when I was working with this stuff, I was a great advocate of this whole movement to manage risk better and so forth. I’ve spent all my life in that sort of area. But by about 2003-2004, I was starting to get very nervous. Because what I could see was that the market had gone from a very legitimate purpose to something which was much more racy and interesting, but also much more dangerous.

Adam Davidson: So these clearly had stopped being insurance somewhere along the way.

Satyajit Das: Oh, absolutely it stopped being insurance.

Adam Davidson: And it became gambling?

Satyajit Das: Well, you know, the line between investing and speculation or gambling in financial markets is always a pretty gray one. But yes.

Alex Blumberg: So, how did we get from one of the safest activities on the planet, insurance, to one of the riskiest, gambling? Well, to understand, you have to understand the key difference between a real insurance policy and a credit default swap. Here, I'll let Gregg Berman explain.

Gregg Berman: The way that I first described the credit default swap is that, you own the bond and you’d like to transfer that risk to someone else. But what if I want to buy protection but I don’t own the bond?

Adam Davidson: Why would I want to buy protection – that’s like buying insurance for a house I don’t own.

Gregg: It is exactly like buying insurance for a house that you don’t own. So it’s like you took out fire insurance on your home, and now I also took out fire insurance on your home, and a thousand other people took out fire insurance on your home. When that happens, what you’re doing is, you’re betting on the house.

Alex Blumberg: So did you get that?

It's like you're using an insurance policy to make a bet. Like, let's say there's a guy named Frank, and he has a life insurance policy. When he dies, the beneficiary will get a million dollars. Now imagine a whole bunch of other people saying, "I want a million dollars if Frank dies, also." And so they all take out insurance policies on him. And then let's say Frank starts to get sick. More people might want an insurance policy on Frank. And the closer he gets to death, the more people buy insurance policies on Frank. That's basically what happens in the credit default swap market.

Here's how it works. A credit default swap is what they call an over-the-counter instrument, meaning simply it's not something that's traded publicly on an exchange, like a stock. It's a private deal between two people. Those two people can be anyone. Well, anyone with more than 5 million dollars. So that means effectively, someone at an investment bank, or a hedge fund, or a big commercial bank like Citibank or Credit Suisse. They all have credit default swap – or CDS – desks.

> Alex Blumberg: So I'm sitting at a desk. At a CDS desk, right?
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> Satyajit Das: Yes, you're at one of the broker-dealers or one of the major investment banks.
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> Alex Blumberg: And how many guys like me are there? There's like 100? 150?
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> Satyajit Das: Oh no there wouldn't be that many. There would probably be, in the bigger desks, about, say, between 15 and 30?

Alex Blumberg: Now, every day, this desk is getting thousands of e-mails and calls from people wanting to enter into credit default swap contracts. Now sometimes those people want it for insurance. They have a bond, from say, the ABC Company. They're a little worried about the ABC Company's financial health. And so they'll call up and say, "Will you sell me credit default swap protection? Will you promise that if ABC Company goes down, you'll guarantee the full value of their bond?" But sometimes, often in fact, the people that are calling don't actually own the bond. They just have a hunch about ABC Company.

> Satyajit Das: So they want to, essentially, bet that ABC Company will default. So he and I agree that if ABC Company defaults, I will pay him a certain amount. And in return he pays me some fees.

Alex Blumberg: Das says that during his time in the industry, the amount of credit default swaps that were used for speculation grew to dwarf the amount that were actually used for insurance. The numbers are staggering. This is Andrew Ang, a professor at Columbia Business School, who studies the credit default swap market.

> Andrew Ang: The corporate bond cash market's approximately 5 trillion dollars, and the notional amount of CDS outstanding is approximately 60 trillion dollars.

Alex Blumberg: In other words, there are 5 trillion dollars worth of bonds issued in the world, but the total amount that people have bet on those bonds is 60 trillion. For every bond, there are 10 people promising to pay the full amount if the bond goes bad. Oh, and there's one more thing.

> Andrew Ang: All of this is unregulated... Partly because they wanted it to be unregulated.

Alex Blumberg: One of the reasons that they wanted it to be unregulated has to do with a word you hear a lot when you talk to finance people. That word is leverage. Here I'll show you.

> Gregg Berman: When you operate on leverage...

> Satyajit Das: The market had become extremely driven by its lust for leverage.

> Andrew Ang: Part of the problem with these swap contracts – they actually have extraordinarily high leverage.

Alex Blumberg: See what I mean? Anyway, this is yet one more finance word out there that people who work with money, they understand instinctively. But the rest of us have only a vague notion of what it means. And the way finance people talk about leverage has changed a little. It used to be spoken of approvingly. Now when they mention it, it's with a little more fear. That's because leverage is one of those things that when it's going your way, it's great. But when it turns on you, it's all over. And leverage is currently wreaking havoc in the credit default swap market. Here's a very basic example of how leverage gives, and how it takes away.

Let's imagine I have a hedge fund with 100 million dollars. And I want to make a killing in the credit default swap market. I start calling and e-mailing to all those credit default swap desks and hedge funds out there, saying, "I'm selling protection. Who wants to buy?" Someone calls me up and says, "I have a billion dollar bond from Lehman Brothers, and I want to insure it." I say, "Great, I'll insure your bond for two percent of its value, every year." You say, "Fine." And we're in business.

Now, let's review these numbers. Two percent of a billion dollars? That's 20 million, which I'm getting every year. My hedge fund? 100 million. So effectively, I've signed one piece of paper, and in five years, I'll double my money. I'm psyched, my investors are psyched. *That* is the upside of leverage. I'm making profits on a billion dollars, even though I only have 100 million.

The downside of leverage is that now I'm on the hook for up to a billion dollars if their bond defaults. And I don't have a billion dollars.

In 2005, though, this particular bet – on a Lehman Brothers bond – seemed like a sure thing. The idea that Lehman Brothers, one of the oldest and largest investment banks in the world, could possibly default, seemed crazy. In 2008, it became scarily, unbelievably real. Just ask AIG.

Now AIG, you may remember, was the big insurance company that had to be rescued by the government two weeks ago. And they had to be rescued because they were about to go bankrupt. And they were about to go bankrupt, as great reporting in the New York Times, among other places, has revealed, because of exactly this scenario. They'd promised over $400 billion to people holding credit default swap agreements with them. Four hundred billion dollars that they didn't have.

But the fact that the biggest insurance company in the world was brought down by these unregulated securities might not even be the scariest part. Because actually, the case of AIG is anomalous. Usually, people who traded them did something different than AIG did, something which was supposed to make them safer, but might possibly have made the whole system more dangerous. They did something called "netting."

So let's go back to my previous example. And let's start with a whole new scenario. I'm the same hedge fund. I've got $100 million. And this time I have a hunch that Lehman Brothers is going to go down. So I go to some company – let's just say AIG. I go to AIG and I say I want to *buy* a credit default swap. I'm not selling this time. I'm buying. I say to them, "I will pay *you* $20 million a year." And the deal is if Lehman goes down, you will owe me a billion dollars.

Now, over the next few months, my hunch starts to look more likely, because Lehman starts looking riskier. Their profits go down. Unfavorable news reports come out about them. And when this happens, they become, basically, more expensive to insure. Just like the more traffic accidents you have, the higher your insurance premiums go. The sicker you look as a company, the more it costs to buy credit default swap protection against you.

And I, now, am perfectly poised to take advantage of this situation. I now go out on the market, and I sell credit default swap protection. But because people are more scared about Lehman, the price is higher. I can now sell it for 40 million dollars a year. So I'm paying 20, but taking in 40. Again, a net profit of 20 million dollars a year. But this time, my position is what they call "hedged." My position is totally safe. If Lehman defaults, I will owe my buyer a billion dollars, but AIG will owe me a billion dollars. The trade totally nets out.

And this situation, where every trade was matched on the other side with another trade? That was much more common. I would sell protection to Morgan Stanley, say, but buy it from Goldman Sachs. Goldman Sachs would sell protection to a hedge fund, who in turn would buy from another hedge fund, and so on down the line, every party netting their position with a counterparty. Again, here's Das.

> Satyajit Das: And the real problem is, that if the chain breaks down anywhere, where one party does not actually honor their contracts, then the losses multiply

rapidly. It links everybody together in this unholy chain. And so what happens is, if somebody has a problem, then everybody else has a problem.

Jon Zucker: Um, the greatest danger... That's a tough question.

Alex Blumberg: This is Jon Zucker, who worked at a credit default swap desk at a major bank for five years. He left in 2007. And he, like a lot of the people I talked to, a lot of people in this field, has a very mathematical mind. He thinks in probabilities, risk spreads, modeling potential outcomes. And if you ask him what the greatest danger is, after careful deliberation, he arrives at a conclusion, which is basically this: if everyone in the chain knew the financial stability of everyone else in the chain, then all of this would be fine. But the problem is, because every deal is private, they don't know.

Jon Zucker: You don't know. It's far from transparent. You know, the notion is that I'm working here at a New York money center bank and some small bank in Asia goes down and suddenly it just hits the tipping point and several other banks fail, and suddenly it's affecting me. I never had a clue.

Alex Blumberg: And this – lack of information – is causing huge problems. It's one reason credit is freezing up. Banks don't want to trade with each other because they don't know what bets anyone's made. And who they've made them with. And who *those* people have made them with.

And this in turn becomes one reason that the government felt it had to step in with a bailout: because all these banks are linked, through these credit default swap contracts. If one bank goes down, they all could.

Alex Blumberg: I guess the question is, that I'm wondering about – basically I'm being affected by people doing this unregulated thing that is speculative in nature. And then things blow up, and then my tax dollars have to be used to come in and sort of bail this out. And I'm mad. First of all, is it fair for me to be mad? And who should I be mad at?

Jon Zucker: That's a great line, "Is it fair for me to be mad, and who should I be mad at?" Um, is it fair for me to be mad? Um…

Alex Blumberg: In keeping with his analytical nature, Jon Zucker didn't answer this question right away. He posed hypothetical scenarios going back the Great Depression. He talked about consequences that could have been foreseen versus consequences that could not have been foreseen. But it didn't seem, at least to me, an attempt to dodge the question so much as an attempt to formulate, right there, an objective value for my potential outrage.

Jon Zucker: I guess what's going through my head is, everybody wants to punish the people who made money in the past 10 years on this business.

Alex Blumberg: I don’t care about that! I want people to be able to make money. I just don’t want their mistakes to cost me. And that’s all I’m asking about.

Jon Zucker: So are you asking the question, “Can I set up a system where their mistakes will never affect you?”

Alex Blumberg: Yeah.

Jon Zucker: ….

Alex Blumberg: That’s a long pause, Jon.

Jon Zucker: Yeah, I’m sorry about that.

Alex Blumberg: No, no. It’s okay. It’s okay.

Jon Zucker: Look I’m a quantitative guy. So I tend to think of the world in terms of models. And the thing that I’m trying to be even-handed about is to say that the regulators completely screwed up. There is a lot of 20/20 review, hindsight review of this, saying people should have caught all this stuff. I’m not 100% sure of that, but one thing I do know is that in terms of intent, there was no intent to regulate. And from that point of view, they should be held accountable for some of the mistakes.

Satyajit Das: Well I think the real problem is, the only people who understand the system now are the techocrats at the banks and so forth who worked within that.

Alex Blumberg: Everyone I talked to agreed that someone, some regulator or someone in power, should have pushed to set up an exchange for credit default swaps, so they could be publicly traded like options, or commodity futures, or all these other financial terms that you've heard of but don't understand, but that as far as we know, are not out destabilizing the global economy.

Professor Andrew Ang said that since they were essentially insurance, they should be regulated like insurance, where strict requirements are set for the companies that sell it. But everyone also seemed to think it's a complex world, and the people who invent these financial products are making small fortunes, and employ armies of people to help them, and that the regulators, in many cases people working at government central banks, at government salaries, will always be playing catch-up.

Satyajit Das: I had a – over the last few years I have had quite a lot to do with central banks. And the central bankers are all very earnest. They’re very intelligent people, and very well meaning. But the problem is, they’ve relied heavily on the banks to tell them what’s going on. And there is obviously a conflict of interest and they have never quite got the full picture. And often when I explain to them something quite minor, like how the CDS market works, their response is, “Oh, I thought it was only for hedging! I didn’t realize it was just purely speculative!” So there is this information gap, which is now having to be filled at very short notice, which is obviously extremely problematic.

Adam Davidson: Can I ask you, when you think about the current global crisis, is this a credit default swap crisis? Is this a mortgage backed security crisis? Is this something bigger than all of those and they're just symptoms?

Satyajit Das: Oh I very definitely think all of these are just symptoms. Essentially the world just has far too much debt. What has happened over the last 30 years is essentially the amount of debt in the financial system has exploded. And I think the problem is the amount of debt that has been created has been made extremely complicated by the financial engineers. There will be enormous, enormous losses, which will beggar belief. When economic historians come to write the history of this period, they will look at this and go, "My god! How did they manage to do this?" We don't even understand the actual quantum of the problem.

Adam Davidson: You mean how big the problem is?

Satyajit Das: Correct. I mean, to give you some perspective, less than 18 months ago Ben Bernanke gave testimony to the effect that he thought the losses from sub-prime would be $50 million and the problems were contained. And he's not an unintelligent man.

Alex Blumberg: Right. In fact he's an expert on the Great Depression.

Satyajit Das: Exactly, so the fact that he could get it so wrong… That perhaps the people who think they understand and think they know perhaps know less than we think they know.

Alex Blumberg: The thing everyone says about Ben Bernanke is that he runs the Fed very differently than his predecessor, Alan Greenspan. He holds meetings that are much more open. Dissenting opinion is encouraged. He listens. He's learning. People have criticized him for this, but today, it might be just what we need.

Music

Ira Glass: Act Three. Swap Cops.

This last couple of weeks, whenever anybody discusses what the government could have done to prevent this financial crisis from happening, it seems to instantly turn into partisan finger pointing in a way that doesn't seem to shed much light on anything. And so this week I called around to a bunch of people who had been federal regulators to try to sidestep that and understand what went wrong. And people talked about a lot of different examples, but the biggest single place that people pointed to, where there could have been regulations but there was just nothing, were these credit default swaps Alex has been talking about. Just last week the chairman of the Securities and Exchange Commission, Christopher Cox, a man who, as we have reported on our program, has mostly sat on the sidelines as this crisis has grown, went before Congress and he said that we've got to go in and regulate what he called the CDS market – credit default swaps.

> Christopher Cox: Neither the SEC nor any regulator has authority over the CDS market, even to require minimum disclosure to the market. As the Congress considers reform of the financial system in the current crisis, I urge you to provide in statute for regulatory authority over the CDS market.

Ira Glass: In fact, lawmakers rejected this very idea back when it could have made a difference. All the way back in 1998.

> Michael Greenberger: In 1998, I was serving as the director of the division of trading and markets at the Commodity Futures Trading Commission.

Ira Glass: That's Michael Greenberger. Now he teaches about these markets in law school and runs the University of Maryland's Center for Health and Homeland Security. But back in 1998, during the Clinton administration, he and his boss at the Commodity Futures Trading Commission noticed that these swaps were becoming more and more prevalent. And they thought that securities law was pretty clear, that this market should be regulated. The only question was how.

> Michael Greenberger: And we essentially put out an extensive questionnaire to the public including the financial services institutions, and said, "We think it should be regulated. We have a lot of flexibility under our statute about how to regulate this market." And that was met with huge resistance, not only within the rest of the Clinton administration with regard to financial regulators there, but in Congress, and a fairly lengthy battle ensued.
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> Ira Glass: And what was the argument against regulating them?
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> Michael Greenberger: The argument against regulating them was that these products are entered into by very sophisticated financial institutions. You can't walk in off the street and buy them. You and I couldn't buy them. But that insurance companies, endowments, pension funds, hedge funds are dealing in these products. And these people are very, very smart and it's a mistake to let government get in their way. And essentially on that thesis – especially, if you'll recall, we were in the middle of the dot com boom, the economy was in surplus. There was not a lot of people who sided with the position that, "Wait, these things can be very toxic and will lead to problems."

Ira Glass: Finally, in December 2000, Congress ended the debate by passing a law that said that credit default swaps, and other swaps like them, would not be regulated. And among people who want to bash Republicans and blame this whole mess on them, the way that this bill came to the floor has become something of a little legend. The bill had been debated and passed by the House of Representatives in the middle of 2000.

But by December it still hadn't been introduced in the Senate, and was considered dead. Then Senator Phil Gramm entered the story. Gramm may be a familiar name to you because until very recently he was John McCain's economic adviser in John McCain's presidential campaign – until Gramm declared that our economic problems really stem from the fact that Americans are a nation of whiners. Gramm got this bill back into consideration in the last few hours before Congress went on Christmas break.

> Michael Greenberger: And it is true that it was brought to the floor of the Senate for the first time on Friday evening, December 15th, 2000, which was the last day of that lame-duck session of Congress. And it came to the floor as a 262-page rider to an 11,000-page appropriation bill. There was a debate on it. Several members of the Senate spoke. But in that environment, when the real focus was on funding the entire federal government for fiscal year 2001, there was no substantive discussion. It passed 95 to nothing, if memory serves.

Ira Glass: In other words, this cannot be laid at the feet of Phil Gramm. This was a bipartisan decision, with Clinton appointees at the Treasury Department and the Securities and Exchange Commission joining Fed Chairman Alan Greenspan, all saying that credit default swaps, and things like them, should not be regulated.

> Michael Greenberger: Quite frankly I think at the time anybody who opposed it was deemed to be a little bit crazy.

Ira Glass: Looking back, Greenberger thinks regulating this market would have made a huge difference in our current situation. Back in the heyday of sub-prime mortgages, when an investor would buy a risky sub-prime mortgage-backed security, it was common to also buy a credit default swap that would pay them back if that security went bad. It was like an insurance policy that helped drive the market.

> Michael Greenberger: But they weren't regulated like insurance policies. If an insurance company had issued this as normal insurance, state insurance regulators would have required that they have adequate capital reserves.
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> Ira Glass: So if there had been regulation, there would have been capital reserves. And just to be sure I understand what you're saying here, that would have helped in two ways. For one thing, there would have been money to pay back when these things went bad. They would have had capital reserves to pay out.
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> Michael Greenberger: That's right, but even more than that, the one thing financial institutions hate to do is set aside capital as a reserve. And they didn't have to do it for these instruments because it wasn't regulated. Had they had to do it, many of them would never have gotten into the business to begin with.

Ira Glass: If companies had to set aside capital for each credit default swap, it would have limited how many they could have done, and it would have made the ones that they did safer. Now this alone would not have prevented all the mess that we're in. Huge macroeconomic forces were at work driving the global pool of investment into lousy mortgages. And if investors did not have credit default swaps they probably would have invented something else just as opaque and risky. But this gets us to the bigger point. Nobody was even trying to restrain the investors. Regulators didn't understand many of these newfangled financial instruments. And they didn't see a problem with the rest.

> Michael Greenberger: If your back door is open in a dangerous neighborhood, the first thing you want to do is close it. Now you could argue that people would break windows. But the first thing you do is close the back door. And the idea that you can have 60 trillion dollars in a financial market, which is more than all the stock sold anywhere in the world, and not have any oversight whatsoever is self-evidently absurd, and we're seeing the end result of that today.
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> Music

Ira Glass: Act Four. Now What?

Well, we got an e-mail on Wednesday from a listener named Will Chen. Let me just read this. "Dear Ira, Alex, Adam and gang…" I hate it when they call us "gang." "You are our only hope. Please do a show that clearly explains the question, 'Should we support the bailout?' If the answer is no, what other options do we have? I'm not dumb or lazy. In addition to listening to NPR and the BBC religiously I also read…" And then he lists all the publications that he reads. "There is so much confusion out there, I really don't know who to trust. After a lot of soul-searching in the last couple of days, I realized there's only one source of information I trust without question, and that is This American Life."

Adam Davidson: Yeah, that is a sad state of affairs.

Ira Glass: That is really something. Poor guy. Um, "Please help us understand this bailout." Okay, so – [rustle of letter] – so Adam, the bailout is passed. What's the answer? Is the bailout a good idea or not?

Adam Davidson: Alright, let me say what is clear, crystal clear to me after spending the last couple of weeks doing nothing but reporting this crisis: it is a severe and scary crisis, and the more I report it, the more scared I have been. It is also clear that spending $700 billion will help. I mean, you throw $700 billion at a problem, you're going to make the problem less bad. But, it's also very clear that the plan we've been hearing all about, the Paulson plan, has a lot of problems. There are a lot of things that a lot of people do not like about it.

Ira Glass: Right, and we've been hearing about that in the news, but we want to just run through some of the big points.

Adam Davidson: Yeah, so some of the big things they don't like about the plan. The main thing is: there's all these crappy assets the banks don't want, and the US government is about to buy them. And so we're about to be the proud owners of $700 billion of crap. Also, these assets have absolutely no price. That is the cause of this crisis. These assets are not moving. These are these mortgage-related investments, mortgage-related securities that no one is willing to buy. And when you can't buy anything you don't know what the price of it is. So by definition, the government is going to have to make up – they're going to have to invent – a price. And if they go too low, they're going to ruin the banks. They're going to give them too little money to save them. They're actually going to make the problem worse. If the government pays too much, well, then the taxpayer has lost out a lot of money and --

Ira Glass: Right, then we're just getting ripped off.

Adam Davidson: Then we're just getting ripped off. So you have to find this magical price that no one knows what it is, so it's really, really complicated.

Ira Glass: So they're going to have to invent a way to do that and it's going to be some sort of difficult process.

Adam Davidson: Yes. It's a very circuitous way to solve the problem. The problem is banks don't have enough money, so they're not lending money and that's freezing up the economy. And this is a very complicated way to get money to the banks.

Ira Glass: Now for the last two weeks while Congress has been debating the Paulson plan and various versions of that, I understand that there's been another way to do the bailout. There's a whole different approach to doing the bailout that lots of economists say is better in a bunch of ways.

Adam Davidson: Yeah, Alex and I have been surveying as many economists as we can find. We've been calling and reading and you know you can never get a whole lot of economists to agree on anything, but I would say of the economists we've surveyed – and I mean leaf-wing, right-wing, libertarian, more progressive – a clear majority of the ones we've surveyed, well over half, prefer another plan. They don't like the Paulson plan as the best plan. They say there's this other thing called a stock-injection plan that is clearly better.

Ira Glass: Okay, stock-injection plan. Now how does this one work?

Adam Davidson: So, in the Paulson plan, what we're doing is giving $700 billion to the banks and in return we get all these toxic assets, these crappy assets.

Ira Glass: We take it off their hands.

Adam Davidson: We take it off their hands. With a stock-injection plan, we still give something like $700 billion to the bank, but in return we get an ownership share of the bank. We get to become stockholders, owners, taxpayers, the government becomes stockholders and owners of the banks.

Ira Glass: And so how is that better?

Adam Davidson: First of all it's just simpler. You avoid that whole pricing of mysterious, mystical asset problem because you just give $10 billion to a bank and then you get a $10 billion share in the bank. It's a much simpler mathematical problem. Also, a lot of the economists I talked to said it's just fairer. It's a better deal for the taxpayer. Because in the Paulson plan, we end up owning all these lousy assets, we don't know what they're worth, if they go down in value we're just on the hook for all of that. In the stock-injection plan, we not only own stock, we would own something called preferred stock which means – it's kind of complicated how it works, but basically the taxpayer is the last one to lose money. The shareholders of the bank would lose their money before we taxpayers would lose money. So we're more protected. We're more likely to actually make money out of this deal and less likely to lose money.

Ira Glass: So if this is better for the taxpayers, why wouldn't we do that? Who's against this?

Adam Davidson: There are a bunch of people against it. One big group is conservative Republicans. They just don't – fundamentally in their guts – don't like the idea of the US government owning shares in private companies. It just smells like socialism to them and they can't support it. But maybe more importantly: banks really, really hate this idea. Look at what happened to AIG, the big insurance giant – because that's sort of what the government did. They bought a huge share of the bank. They all but zeroed out the value of the shares. So all of the current shareholders of AIG just lost billions of dollars.

Ira Glass: Their stock is just worth –

Adam Davidson: Yeah, virtually nothing. And the government fired the chief executive of AIG, completely took it over.

Ira Glass: See, I like that. I like that these guys end up getting punished under this plan.

Adam Davidson: Yeah, a lot of – that's not just a moral issue or a political issue. That's an actual economic issue. An economy works better when people pay the cost for bad decisions. And the Paulson plan doesn't do that as much as a stock-injection plan. So from the bank's perspective, this is absolutely a no-brainer. Let's say I give you two options, Ira. One option is, I come, I give you 1,000 bucks and I take all of the crap out of your basement and you get to keep the thousand bucks. That's the Paulson plan. The other option is I come, I give you 1,000 bucks and I get to move into your house. I become a co-owner of the house. I might get to kick you out of the house and take all your stuff. I mean, from the bank's perspective, from the shareholders', from the executives' – it's a no-brainer. Of course they like the Paulson plan. And the bank lobby is a powerful, huge lobby. You can just imagine how powerful they are. How many strings they can pull on Capitol Hill.

Ira Glass: And they would oppose anything like that?

Adam Davidson: I talked to a bank lobbyist. He told me there are over 600 professional lobbying groups. Thousands of people are working hard to promote the Paulson plan and to weaken any stock-injection plan.

Ira Glass: Weaken – that is, as if it were ever actually seriously considered.

Adam Davidson: Well that's what's interesting. Until last night, Thursday, I and everyone – all the experts I talked to, all the people on Capitol Hill – were under the impression the stock-injection plan was simply not on the table. You and I worked late last night. I was in a cab on the way home. I got a call from a guy I know who's pretty well-connected, right around midnight, and he told me, "Guess what? The stock injection plan is in the Senate bill that was passed and it's in the House bill. I woke up this morning and I still could barely believe it. I've been calling around. It was kind of a dramatic morning. The first few people I called said, "No, that's ridiculous. There's no way that could have gotten in, that's impossible." Over the course of the morning, I got more and more confirmation. And basically what happened is someone – and we still don't know who – put in very subtle language into the Senate bill that gives this as an option to the Treasury Secretary.

Ira Glass: And so is this in the bill that got taken up in the House on Friday? You and I are talking Friday afternoon at around 4:30 Eastern time, and that the President just signed into law? Is it in that bill that got signed into law?

Adam Davidson: That's our understanding, yeah. There's still the main plan, which is buying the crappy assets. That's still the core idea. But the Treasury Secretary has as an option, at his discretion, the ability to do this other plan, the one that many economists prefer, the stock injection plan.

Ira Glass: Okay, so at least that's in there. But to get to the original question. This thing has now been signed into law. How should we feel about this?

Adam Davidson: It is not hyperbole to say that there is a severe financial crisis. All these dire warnings you're hearing – this is not Wall Street fat cats trying to make some money. This is serious. Alex and I have seen it. This week we saw the crisis spread to Europe, which had been saying that they were immune to it. It's already seeping out to Main Street, or whatever cliché you want –

Ira Glass: Right, in the ways that we reported earlier in the show.

Adam Davidson: In the ways we've been telling you about. The majority of economists

I have talked to would say the following: this crisis is severe. It's going to get worse. Something needs to be done. The original plan was not great. This plan is a lot better. This plan is probably the best we can get. And something has to happen sooner than later.

Ira Glass: Well, Adam. Thank you for another frightening hour.

Adam Davidson: Yeah. This one scares me a whole lot more than the last one.

Ira Glass: Alright. Well, thank you, Adam.

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