This American Life Episode Transcript
Program #382
The Watchmen

Ira Glass: Previously on *This American Life*.

> CLIP 1: No-income, no-asset loans, that's a liar's loan. You are… We are telling you to lie to us, effectively.
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> CLIP 2: I wouldn't have loaned me the money and nobody that I know would have loaned me the money.
>
> CLIP 3: This is where we have to talk about Alan Greenspan right?
>
> CLIP 4: Yes we have to.
>
> CLIP 5: The balance sheets, of these banks is, as far as we know, a huge lie.

Ira Glass: Over the last year we've brought you many stories explaining exactly how the economy collapsed. We've heard about mortgage-backed securities and derivatives and bank balance sheets. And today, looking for a little ray of hope about our country's economic plight, we turn to the past.

> Michael Perino: He was and amazing courtroom lawyer. He was relentless. He would not allow witnesses to duck and dodge, and he had a nearly photographic memory. His staff would marvel that he would read a briefing memo once, and you know, he would remember every name, every fact, every figure.

Ira Glass: This is Michael Perino, a law professor who is writing a book about Ferdinand Pecora. Pecora was the lead attorney in the hearings of the Senate Banking Committee back in the 1930s, and when Pecora got the job, he turned the hearings from an unimportant and not terribly useful exercise into a real investigation of Wall Street and the causes of the 1929 stock market collapse and The Great Depression. Pecora was a former district attorney, and he did this very, very well.

> Michael Perino: He created outrage. And it was that, and that frustration at Wall Street, that created the political environment in which Congress had to pass the first federal securities legislation, had to pass new banking regulation, had to create the FDIC and federal insurance for bank deposits. Even Roosevelt drew a direct causal line between the wrongdoing that Pecora uncovered and his ability to push through legislation in that first 100 days of his administration; passage of so much legislation so quickly.

Ira Glass: Did they go into the hearings looking for bad guys? Or did they go into the hearings looking to come up with an analysis of here is what went wrong and here's what we've got to fix, and to have a kind of teaching moment for the country?

Michael Perino: It's a good question. Pecora described his job as trying to make what was going on in Wall Street, very complex and arcane transactions, he wanted to make them into common sense; to take these very complex transactions, and really turn them into very simple morality tales of right and wrong.

Ira Glass: In one of the famous morality tales from the hearings, Pecora put Charles Mitchell into the witness chair. Mitchell was the head of National City Bank, which is an institution that we know today just as Citibank, and Pecora asked him about some bonds that his bank sold, bonds that had been issued by Latin American countries. The banks' own internal documents showed that the bank thought that maybe these bonds were no good.

Michael Perino: Their internal memos all said, these securities present huge risk, there is great possibility that these things are never going to get repaid. And National City never told any of that stuff to the investors. And when Pecora asked Mitchell about it, he seemed surprised. He said, why would the investors want to know anything about that? And that led directly to the passage of the first federal securities laws, the Securities Act of 1933, which required exactly that kind of disclosure when securities were sold to the public.

Ira Glass: And there was actually a show trial aspect to this, right? Like it wasn't all substantive seriousness, right? Could you talk about that other part?

Michael Perino: Yes. There were times when it descended into the absurd. During the hearings involving J.P. Morgan… This was the media event of the day. They brought special telegraph lines into The Capitol so that reporters could get their stories out quickly.

NEWSREEL: In the committee room, Chairman Fletcher swears in J.P. Morgan, who explains the function of private bankers…

Ira Glass: This is one of the few times that flash photography or filming was allowed in the hearing room, and it led to the most famous photograph of a hearing, which came after a senator complained that, all of the media that had turned out to see J.P. Morgan, were turning the proceedings into a circus.

Michael Perino: Well, one of the promoters for Ringling Brothers Circus picked up on this comment, and he showed up the next day in the hearing room with a woman named Lea Graff, who was one of the circus midgets for Ringling Brothers. And he had the idea that what he termed, the shortest woman in the world, should sit on the lap of the world's richest man. And so there was Lea Graff sitting on the lap of J.P. Morgan.

Ira Glass: Reading these hearings, do you think we should do this now?

Michael Perino: You know, there's talk of doing it now but my concern is how it's done. What I don't want to see is some hearings that are just the show without the substance.

Ira Glass: And do you feel that that's what we got so far?

Michael Perino: So far I think that's what we've gotten.

Ira Glass: So basically they call these executives, they yell at them about executive compensation…

Michael Perino: Exactly. Just do a little public humiliation. And I think that doesn't do anybody any good.

Ira Glass: We talked about this for a while. I told Michael Perino that I was surprised that President Obama, for of all his communication skills, hasn't really presented the public with a real analysis of what went wrong on Wall Street. The most the President usually says is that the problem is that the stuff that people did on Wall Street that got us into this mess, was all perfectly legal. Well sitting in on this interview with me was NPR Economics Correspondent Adam Davidson, who appears on our program all the time reporting on these issues. And he's actually been looking into what kind of hearings Congress might hold on the banking crisis.

Adam Davidson: I talked to someone people in Congress today, who asked that I not say who it was, but this person said that they don't want the Pecora Hearings as a model. They see the 9/11 Commission as a model, and basically this person who works in Congress for Congress people, said we don't trust Congress people. If you have hearings inside Congress, it's going to be…

Michael Perino: … a circus…

Adam Davidson: Democrats versus Republicans. It's going to be ugly. If it's outside of Congress, that's your only shot.

Michael Perino: You know, I think the other issue that is in a lot of people's minds, quite frankly, is look at all the money that's coming from the financial services industry that flows into Congress, particularly into the committees that would actually hold these hearings. Are these really the people that we want to have? Maybe an independent commission is a better way to go, than just having a Senate committee do the hearings.

Adam Davidson: So you're saying America needs an independent group of people, not paid by banks and lobbyists, not partisan, open-minded, fearless investigators.

Michael Perino: I think the fewer conflicts we have on that committee, the better.

Adam Davidson: Hey Ira…

Ira Glass: Yes?

Adam Davidson: I think this is a job for us.

Ira Glass: Well until our government's hearings get going, if they ever get going, we today would like to make her own modest contribution, our own mini-hearing, because we do not want to wait. Our hearing will not last 17 months, we don't have subpoena power to force the most powerful people on Wall Street to come before us to testify, but we do have a question, for our hearing. And it's this: there were regulators, and there were watchdogs who were supposed to be overseeing the banks and the finance industry to make sure that things wouldn't blow up like they have. Clearly something went wrong, right? And we ask today, where were the watchmen? And so I call this program to order. From WBEZ Chicago, it's *This American Life,* distributed by Public Radio International. I'm Ira Glass. Our hearing today in two parts: we have one investigator who looked at government watchmen, and the one who looked at the watchman in the private industry who were supposed to verify the safety of these instruments that collapsed. Stay with us.

Ira Glass: Okay, settle down. Order. Our first investigator we sent out with this assignment. We asked her to take one financial institution that really screwed up, and tell us what was the deal with the regulators. Where were the government officials who were supposed to be overseeing that institution? Well AIG seemed like a good institution to pick. The government has now committed $170 billion, that's billion with a "B," into that company which dwarfs the bailouts of GM, Citibank and Bank of America. Our intrepid investigator, Reporter Chana Joffe-Walt, first set out to answer what first seemed like a very simple question: which government regulator was supposed to be regulating AIG?

Chana Joffe-Walt: You and I, we read about the collapse of AIG on a Tuesday morning in the newspaper. But Eric Dinallo got a personal phone call Friday night. Dinallo's the insurance regulator for New York State, and it was a AIG's

Chief Financial Officer on his cellphone: Eric, we need to do plus discuss a liquidity problem.

> Eric Dinallo: I was in our family car driving toward to our cabin in Putnam County, and when I heard the amounts, the enormity of it, I was shocked.
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> Chana Joffe-Walt: What numbers did you hear that shocked you?
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> Eric Dinallo: Pretty quickly we started hearing numbers in the $40 billion range. That was even over on the phone Friday night.

Chana Joffe-Walt: Saturday morning Dinallo heads into AIG. At the door: put the Blackberry away sir, please. He does, and enters this conference room. There is no space at the table. AIG executives, Wall Street CEOs, bankers, advisors, treasury people, they're all there, sitting next to a bunch of snacks no one has touched. AIG needs cash – and no one in the room is offering it up. Dinallo looks at his Deputy, Hampton Finer. Finer looks around the room.

> Hampton Finer: I think what we thought to ourselves is this is the nightmare, this is sort of every insurance supervisor's nightmare.
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> Chana Joffe-Walt: And you were shocked by that?
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> Hampton Finer: Very shocked. Yes.

Chana Joffe-Walt: AIG's collapse was shocking to you and me? Sure. It was shocking to people who held AIG insurance policies? Okay. But these guys, Eric Dinallo and Hampton Finer, they are regulators… regulators… New York State insurance regulators: guys who talk about AIG in their morning meetings, guys who go out to AIG companies and do examinations and hold conferences about AIG quarterly reports. These are exactly the guys that you hope will not be surprised when the enormous insurance giant, based in New York, calls its regulator and says, we have no money. I asked Superintendent Dinallo about that: you're the New York insurance regulator, doesn't that make you the guy in charge?

> Eric Dinallo: We're the regulator for the domestic insurance companies that are domesticated in New York. But the other side was AIG Financial Products Division that really was the part of the company that caused the taxpayer to have to put up the hundreds of billions of dollars that everyone is appropriately upset about.
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> Chana Joffe-Walt: So, the healthy part, your part, the bad part, not your part?
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> Eric Dinallo: Well, yes, that is sort of a simple way of putting it. Yes.

Chana Joffe-Walt: Where was Financial Products based?

Eric Dinallo: I think it was based in Connecticut, Greenwich I think, and also in London.

Chana Joffe-Walt: A couple of minutes of Google and some secretaries, and the next day, I'm asking Commissioner Thomas Sullivan the same question.

Chana Joffe-Walt: You're the insurance regulator of Connecticut and AIG, a huge insurance company, has their Financial Products Group, which was a division that was dealing with all of these exotic derivatives, they had an office in Connecticut. So, aren't you responsible?

Thomas Sullivan: No. Financial Products is not a insurance company.

Chana Joffe-Walt: But, AIG is an insurance company.

Thomas Sullivan: Well AIG the holding company is not an insurance company.

Chana Joffe-Walt: Next, I called London. I called other places where AIG had big offices: Japan, China. I called France. AIG financial products had a subsidiary in France.

Corinne Dromer: I am Corinne Dromer, I am the Deputy Director of Communication.

Chana Joffe-Walt: And Dromer, do I spell it…

Corinne Dromer: D-R-O-M-E-R…

Chana Joffe-Walt: Great. Okay.

Corinne Dromer: I'm speaking off the record only.

Chana Joffe-Walt: Oh, remember, I just asked if I could record our conversation.

Corinne Dromer: You can record of course, but it's really off the record.

Chana Joffe-Walt: Okay, anyway, Dromer just proceeded to tell me in, I have to say, the most snooty way possible, obviously the subsidiary was regulated by the French regulator, but the subsidiary didn't mess up the global economy. Financial products did. And Financial Products is a U.S. company. France not responsible for American mess-ups.

Chana Joffe-Walt: At a low point, not sure where else to try, I even called the Federal Aviation Administration, the FAA. After all, AIG did own a big airplane-leasing company, called ILFC, and the FAA regulates air travel, so I figure, what the hell? And I actually got a voicemail back from them.

> Les Door: Hi, it's Les Door at the FAA in Washington, D.C. We don't actually oversee ILFC, you know we really don't oversee the sale or leasing of aircraft. Now, if an airline adds an aircraft, we would check the lease, but as far as direct oversight, we really don't oversee that. So, if you have any questions…

Chana Joffe-Walt: AIG has approximately 400 regulators in 150 countries, and all 50 states. I think I called 35 of them. Do you know how hard it is to get a regulator to even talk to you, to even say the words 'not my fault'? Which, by the way, is which was what every single one of them told me. Which sounds crazy right? And unsatisfying and frustrating and confusing, but also unfortunately, mostly legit. AIG was this enormous company, right? Gigantic international operations, $1 trillion in assets. And those 400 regulators, they were each handed a small chunk of the monster. I asked Eric Dinallo, the New York Insurance Regulator about that.

> Chana Joffe-Walt: What percentage of AIG would you say you are responsible for looking after?
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> Eric Dinallo: I'd have to check, I don't know the exact percentage of the property and life divisions put together internationally, so I don't want to speculate.
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> Chana Joffe-Walt: Can we find out?
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> Eric Dinallo: Yes. We can do that.
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> Chana Joffe-Walt: Thanks.

Chana Joffe-Walt: This took 18 minutes, four men in suits, one computer, two cell phones and I'm not sure how many calculators, to figure out what portion of AIG this one office in charge of. Here's just a little piece of all of that.

> Eric Dinallo: Is that okay? Yeah. Did the numbers add up about the same? What did you get? And then he started banging, and then the reporter is going to say he started banging his head on the wall.

Chana Joffe-Walt: He did bang his head on the wall. And then?

Eric Dinallo: I think on an assets basis, it would be somewhere between 7% and 10%.

Chana Joffe-Walt: Does that mean that Connecticut has 5%, and Missouri has 3%, and Alabama has 4%?

Eric Dinallo: Oh, I'm sure. I'm sure if you went through and did an analysis, it would definitely be segmented similarly, actually globally.

Chana Joffe-Walt: And that means that all of those states have their own individual regulators, all those countries have their individual regulators, maybe the regions have regulators?

Eric Dinallo: Yes. That's our system.

Chana Joffe-Walt: In other words, Eric Dinallo is great at property and life and car and death insurance New York State. He is not, no offense Dinallo, a star at airplane leasing, insurance in Bangladesh, real estate in Tokyo. So Dinallo focuses in on his one thing, he's given 7-10% of AIG, and he says I regulated my 7-10% very well thank you. The problem was that all these regulators, with their 5% here, and 3% there, it didn't all add up to 100% of the company. There were a few percentage points missing, parts of the company that nobody had specific jurisdiction over. And that right there became the story of what went wrong with AIG. Federal Reserve Chairman Ben Bernanke told Congress:

Ben Bernanke: AIG exploited a huge gap in the regulatory system. There was no oversight of the financial products division.

Chana Joffe-Walt: The financial products division was the part of the company that bought and sold derivatives, which as you may have heard were the complicated financial instruments that nearly sunk AIG. And Bernanke was saying, no one was regulating that part of the company. And for months that story stuck. And then one day Donald Kohn also with the Fed, he's telling that story. He's in a congressional hearing, and is going on about how unfortunately no one was watching that part of the company, and no one was watching over the whole thing, the whole of AIG. Senators dutifully asking follow-ups, and then they get interrupted. A hunched man peeking over his glasses says, 'Um, we were. We were in charge. We screwed up.'

Scott Polakoff: Senator, may I make a comment?

Senator…: Yes.

Scott Polakoff: It's time for OTS to raise-up our hands and say we have some responsibility and accountability here. This entity was deemed a savings and loan holding company. We were deemed an acceptable regulator for both US domestic and international operations. There it was. Scott Polakoff, Interim Director of the Office of Thrift Supervision, OTS, saying, blame us. Thrifts are the same as savings and loans, they are a type of bank, and the OTS regulates thrifts, and holding companies that own thrifts. And what Scott Polakoff was saying was, we were the thrift regulator, and we were the regulator for the whole company, what's called the lead regulator, for all of AIG. We were supposed to fill in all those gaps. And this moment, you can tell watching the hearing that Congressmen, they're kind of taking aback. They actually seem sort of incredulous. Senator Mel Martinez leans in:

Mel Martinez: Mr. Polakoff, or Director Polakoff, I wanted to ask you, I was struck by your acknowledgment that perhaps you are the regulator that we have been looking for. I think we had assumed that there wasn't one…

Chana Joffe-Walt: Polakoff says yes, I'm the one sir. Senator Jeb Hensarling from Texas, in a hearing two weeks later, he asks Polakoff, wait, did you say that?

Jeb Hensarling: I believe I heard in an earlier answer to one of the questions, I believe I heard you say that OTS in 2004 should have stopped the book of business that I think you are alluding to, the CDS and the AIG securities lending commitments, did I understand you correctly?

Scott Polakoff: Yes sir.

Jeb Hensarling: So if you said you should have stopped it in 2004, that implies you could have stopped in 2004? Is that correct?

Scott Polakoff: Yes sir.

Chana Joffe-Walt: Senator Hensarling then says, so it wasn't that you didn't have the authority, it wasn't a lack of resources, it wasn't a lack of experience; you just flat made a mistake? Polakoff says once again, yes sir.

Chana Joffe-Walt: So here's this guy, standing up and saying, 'yes me,' I'm the one you've been looking for, and everyone kind of goes, you? Who are you? I'm guessing you've never heard of the Office of Thrift Supervision. The OTS is the smallest federal bank regulator, and it's the youngest, 20 years old. I did call the OTS several times and they wouldn't talk to me about AIG. A press guy told me "we've testified before Congress twice, we're not going to go beyond that." So then I started on the regulation expert people, like Patricia McCoy, she's a law professor at the University of Connecticut, someone in who in her free time sits down with a pen and paper and does bank autopsies. She'll research failed institutions, look at what went wrong, you know, for fun. So one night, McCoy is making this graph of major bank failures from 07' and 08.'

> Patricia McCoy: It was late at night. I tend to work late at night. I had filled in the asset sizes, and then I had to do a little research to see who the regulators were. And when I started typing in OTS, OTS, OTS! I went, what happened at this agency? It's been flying under the radar and we didn't notice.

Chana Joffe-Walt: Which institutions were you saying and naming, and writing OTS next to it?

> Patricia McCoy: Indy Mac, Washington Mutual, Downey Savings and Loan, NetBank…

Chana Joffe-Walt: You might recognize some of those names: for instance, Indy Mac, the most expensive bank failure of this crisis? Regulated by the OTS. Second most expensive? BankUnited, regulated by the OTS. The largest bank ever to fail, Washington Mutual? OTS. Other OTS claims-to-fame? Countrywide and AIG.

> William Black: The reputation of the Office of Thrift Supervision was that it was the weakest, and the laxest, and it was indeed outright friendly to the worst of the non-prime lending.

Chana Joffe-Walt: This is William Black. He's is a professor at the University of Missouri-Kansas City, and he used to work as a lawyer for the Office of Thrift Supervision back in the early '90s. He says that idea that that OTS could ever go up against AIG, the world's largest insurance company? Well…

> William Black: No contest. It's like the super-heavyweight of the world, going up against the 65 lb, 13-year-old, class weakling. That was the OTS.

Chana Joffe-Walt: You think about how banks get their regulators, and you think, they just get assigned one, someone tells you who you regulator is? No. If you're a national bank, you have four choices. And maybe you knew this already, but this seemed insane to me, financial institutions? They choose their regulators. They go regulator shopping. And when AIG was regulator shopping, the OTS looked pretty good. The OTS was actually created because another regulator really messed up, the Federal Home Loan Bank Board. They used to regulate savings and loans, until the Savings and Loans crisis of the late 1980s, at which point Congress abolished it, and created the OTS. And I talked to several people worked for that predecessor agency, the Bank Board, and they describe that on that day, the day the OTS was created, they left the office, these agency employees and they walked across the street to a hotel they turned on the TV, and they sat and watched the first President Bush stand up at a podium and declare 'never again will America allow any insured institution operate without enough money.' And then the agency employees watched as the President trashed their agency. The press conference ended, they turned off the TV, left the hotel, crossed the street, and went back to work. Pretty soon someone came by and changed the sign: The Office of Thrift Supervision.

Chana Joffe-Walt: So there was this newborn savings-and-loan regulator, and for while it did try to change its ways, a new administration brought in new management. But the OTS was in a tough spot: savings and loans was dropping like flies, and this was a problem for the OTS, a serious problem, because and this brings us to an even more insane fact about the way our system of regulation works, federal bank regulators, they're paid by the banks, the people they're supposed to be regulating. They don't get a government budget. The more banks they regulate the more money they have. So if you're the thrift regulator, and hundreds of threats just drop dead, that's a problem for you.

> William Black: The OTS was losing revenue and losing revenue and it was shrinking its staff, so the staff feared that they would lose their jobs, and of course the bosses feared why do they need an agency, if there are fewer and fewer institutions, so they were desperate to try and get banks to convert so they'd be regulated by the Office of Thrift Supervision, and the Office of Thrift Supervision would get the revenue and be able to stay in business.

Chana Joffe-Walt: Now, the OTS couldn't hold a press conference, and say hello, we're having a going-out-of-business sale. We'll be the laxest regulator in town, come on down, sign up. No, instead, they went to industry meetings. They talked about the services they offered, how you could do more things. And they did make sure to show up at other kinds of press conferences, make their presence known. Like this one time, a bunch of federal regulators were getting together to announce a campaign to ease regulation, cut through red tape, and James Gilleran, the head of the Office of Thrift Supervision shows up for the photo op. Gilleran, just by the way, didn't return calls so Patricia McCoy and William Black, they paint the picture.

> Patricia McCoy: They were essentially standing in a horseshoe, behind them it's a banner that announces the new regulatory relief campaign.

> William Black: And they're all grinning broadly, and poised over a stack of the federal regulations to demonstrate their intention to cut through all the federal regulations.

> Patricia McCoy: The other federal regulators showed up at the press conference with garden shears, and each of them is holding up their instrument ready to clip, very picturesque. Gilleran showed up with a chainsaw.

Chana Joffe-Walt: The OTS guy is holding a chainsaw?

Patricia McCoy: Yes. And he's standing in front.

Chana Joffe-Walt: Companies got the message. In 2000, General Motors bought a thrift. The next year, so did GE. A few years after that, H&R Block had a thrift. And in 2000, a large insurance conglomerate called AIG opened a small savings an loan in Delaware. It was one 1000^{th} of AIG's total balance sheet but, that meant that AIG could get OTS as it's lead regulator, overseeing its entire business, all of it: the holding company regulator, the international regulator.

Chana Joffe-Walt: Calling up the world regulators and asking, "which one of you screwed up with AIG?" Extremely frustrating. But talking to people about the OTS? I've got to say, it's pretty satisfying. Hearing, 'man, they screwed up.' Finally, it's clear-cut, simple answer, easy villain. Great. Should've stopped there.

Mike Roster: I don't care who was the regulator. I don't think they would've caught this. And I hope we don't get diverted to that sideshow. It's getting diverted to sideshows, that unfortunately doesn't solve things.

Chana Joffe-Walt: This is Mike Roster, he's a veteran regulation lawyer, and he says, sure you can dump on OTS if you want. But spread out your anger a little. First of all, save some for Congress. Back in December of 2000, Congress passed legislation that made it incredibly hard to regulate the exact part of AIG that caused all he problems. It was this law called the Commodity Futures Modernization Act. And it said, certain kinds of derivatives, those complicated financial instruments at the heart of AIG's problems, could not be regulated by the federal agencies that typically watch over that kind of thing. Let me just repeat that: in 2000, Congress decided that federal regulators, could not regulate the thing that got AIG into trouble. President Clinton signed that act into law. In retrospect, it seems crazy, but at the time derivatives were still a pretty small market. Politicians just didn't see the risk. Which means, in the end, that even if the OTS had really, really wanted to regulate the hell out of AIG, in theory, as the lead, overarching regulator they could do it, but they would've had to step in and do things that were really the specialized job of this other federal agency, a job Congress had just barred that agency from doing. And Rosser says don't use all your anger on Congress either. How about all those other firms that did deals with AIG's all firms with regulators, by the way, who thought everything looked great. And they thought everything looked great at AIG not because the OTS was doing such a bang up job regulating. No one, Rosser says, was paying any attention to the OTS.

Mike Roster: No. No. No. The reality is no. If you're doing trades with AIG, if you're buying billions of dollars of insurance from them, you're not looking at the OTS. You're actually looking at the Standard & Poor's and Moody's ratings. There was AIG getting a triple-A rating, so those are very smart people at the rating agencies.

Chana Joffe-Walt: So, if you want to know which regulator to blame AIG on, it's not the state insurance regulators, or London, definitely not France, the Office of Thrift Supervision officially takes the blame, but then we can also point the finger at Congress and the rating agencies… the rating agencies, now they were supposed to be looking at each and every bond, each and every derivative to make sure it was safe. The rating agencies are a whole other can of worms, and one we will open in just a minute.

Ira Glass: Well I couldn't have said that better myself. Thank you Chana Joffe-Walt. We have can openers at the ready, and worms ready for their close-up… and by worms I don't mean to disparage anyone in our nation's financial industry. That's in a minute, from Chicago Public Radio and Public Radio International, when our program continues.

Ira Glass: It's *This American Life*. I'm Ira Glass. Come to order! Some to order, please. Well we at our program are hungry for the kind of hearings they had back in the 1930s after the stock market crash, where investigator Ferdinand Pecora made complicated Wall Street shenanigans understandable to everybody. And so, because we don't have those yet, we are holding our own hearings today, right now. And we turn our attention now in these hearings, to the credit rating agencies. When all of those financial instruments that brought down our economy, the mortgage backed securities the derivatives, all that stuff, were originally issued, three rating agencies Standard & Poor's, Moody's and Fitch, gave many of those things their top rating of triple-A, meaning very low risk, as safe as can be. Because of the great ratings, trillions of dollars went into those financial instruments and into the housing market, creating a big bubble, of course. And of course, the ratings did not turn out to be correct. Standard & Poor's, for example, has downgraded roughly half, half, of its triple A's, some way down almost to the lowest level, triple-C. The rating agencies just had one job to do: assess how risky the things were, and it seems pretty clear, on that job they failed. So should they take a lot of blame for the global financial crisis? Well, our hearing continues. Here's Alex Blumberg and David Kestenbaum.

David Kestenbaum: Pretty much anyone who issues a bond gets a rating from the rating agencies. Companies, cities, even entire countries get rated. Standard & Poor's gives IBM an A+. The St. Louis Public School District R-9 gets a double-A-. Argentina, a B-.

Alex Blumberg: There's this old book, "Moody's Analysis of Investments, Steam Railroads, 1917." Adirondack Railroad? Triple-A rating. Aberdeen and Rockfish Railroad? Stay away from that one, they got a B. And so for something like 100 years, this is what the rating agencies have done, tried to answer one simple and critical question: if I loan someone money, buy one of their bonds, am I going to get my money back?

David Kestenbaum: But, in the early 1980s, a different kind of bond came along. Today, they go by many names: mortgage-backed securities, collateralized debt obligations. They all fall under the broad heading of structured finance, which is basically that thing you've heard a lot about, thousands of loans and mortgages pooled together in bundles and then sold as bonds. And the numbers grew. Over the last decade, Wall Street created trillions of dollars of these bonds. And the rating agencies rated them. Frank Raiter worked for one of these agencies, Standard & Poor's in the structured finance division.

> Frank Raiter: We were the fastest-growing, most-profitable group within Standard & Poor's for a while, at least in 2005, 2004/2005.

David Kestenbaum: These days, Frank Raiter lives far away from Wall Street. In fact, he's out of cell phone reach entirely. He's clearing himself a little farm in rural Virginia. He does have a office, but it's got a turtle in it. And the reason I wanted to talk to him is that Frank Raiter was at Standard & Poor's at the very beginning, when the structured finance products are really taking off.

Alex Blumberg: So let's say you have a mortgage-backed security. It's made up of like 5,000 or so mortgages. Basically, you have to estimate how safe each of those 5,000 people is, how likely they are to default.

David Kestenbaum: Raiter says when he first started working at Standard & Poor's they had databases on all kinds of borrowers, ones with good credit, bad credit, and to figure out how likely the borrower is to default, they hired a company, a math company, and the math company made them a computer model, based on an actual equation.

> Frank Raiter: It's used in code breaking and encryption, and in areas like that.
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> David Kestenbaum: But there was an actual equation?
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> Frank Raiter: Oh yes, there is an actual econometric equation.
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> David Kestenbaum: Did you ever see the equation?
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> Frank Raiter: Yes.
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> David Kestenbaum: What did it look like?
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> Frank Raiter: It looked like a lot of Greek letters.

David Kestenbaum: So for the first five years or so that Frank was with Standard & Poor's things went pretty well, he says. They were taking their historical data about borrower behavior, feeding it into the model and using the results to issue their ratings. But then in the early 2000s, as we've heard, banks started issuing mortgages to people who wouldn't have gotten them before: people with bad credit scores, putting no money down, and not saying what kind of job they had. There wasn't much history on how this kind of borrower would behave. The equation couldn't handle them, and that worried Frank. They says they had to basically guess at the default probabilities, put magic numbers into the model. Raiter says the only way that seemed okay to him was if they started collecting data on these new borrowers to see how they performed over time, so they'd have some real historical data to put into the equation. But when he went to his bosses saying we need a new model, we need to collect more data, this is the answer he got.

> Frank Raiter: You've got a 94% market share, and you're not going to get any more if we build a new model. To them was just a tool, and we were making a lot of money with it so why change it?
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> David Kestenbaum: Did they say that to you specifically in conversation, look we have 94% market share, like why do we need a better model?
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> Frank Raiter: Yes. That was a conversation I had on several occasions.
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> Jim Finkel: They should have said, you know what, we don't have enough information about this new product to ascribe a rating to it. But they couldn't do that.

Alex Blumberg: This brings us to witness #2, Jim Finkel. He works at a company called Dynamic Credit, and some of you might remember him from an earlier *This American Life* episode, "The Giant Pool of Money." He was the guy putting together some of these structured finance deals the rating agencies were rating. He was with Wall Street, and he says what a lot of people say. One reason the rating agencies didn't just say no, put the brakes on everything, it would've cost them money. The rating agencies get paid by the Wall Street investment banks who were creating and selling the bonds. If a rating agency said to one of them, I'm not going to rate this newfangled bond of yours, I don't have enough information, Wall Street had an answer. A very persuasive one.

> Jim Finkel: Wall Street said, 'hey, if you don't, the guy across the street will. And we'll get them all the business.' And they just played the rating agencies off one another, and the rating agencies were basically facing, oh, are we willing to give up 40% of our revenues because we're saying were not ready to rate this kind of new product? It would have been financial suicide for them.
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> Felicia Grumet: Does it mean they get rid of their rules altogether? No. But does it mean they might make compromises here or there? Maybe.

Alex Blumberg: Felicia Grumet, like Jim Finkel, worked on Wall Street, at Bear Stearns. We'll call her witness 2A. She also created these bonds. She explained how she would try and get the rating she wanted from the rating agencies. For instance, sometimes she'd have a new type of deal, that she needed to get rated. The rating agencies didn't have a set methodology for a something new like this, and so her team would propose a structure to try and get as much of the deal Triple-A as possible.

> Felicia Grumet: In some ways we were part of developing the methodology with them, because we'd be trying to argue, you should look at it this way, or that way, and they would go off on their end, in their committees or whatever, and they would come back and say to us this is our expected levels of AAA, and other bonds in the structure, and we might say well that doesn't work. You have to go back to the drawing board so to speak.
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> Alex Blumberg: Meaning more triple-A?
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> Felicia Grumet: Did it happen that specifically, I don't know, but that was just part of it.

Alex Blumberg: Felicia and I talked for a long time, and she said eking the most out of every deal, scouring the rules for every loophole, that was just what you did. That was everyone's job on Wall Street.

> Felicia Grumet: It makes me feel really bad actually, it's very hard for me to acknowledge.
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> Alex Blumberg: Why does it make you feel bad?
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> Felicia Grumet: Because I knew what I was doing.
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> Alex Blumberg: Yeah.
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> Felicia Grumet: I knew I was doing things to get around the rules. I wasn't proud of it but I did it anyway.
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> David Kestenbaum: When a lot of these securities were being rated triple-A, did you just think there is no way that's triple-A?
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> Jim Finkel: Absolutely.

Alex Blumberg: Again, Structured Finance Manager Jim Finkel.

> Jim Finkel: There were ratings that we saw that made no sense to us. We knew the rating agency models and metrics and we could replicate them ourselves. And, we couldn't make sense of what they were doing.
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> David Kestenbaum: Did they rate your stuff higher than you thought it should have been rated?
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> Jim Finkel: I think we marveled at the ratings that all of these CDO products got. It was very hard to say that we didn't enjoy the fact that we could get a rating, and to be honest with you that and another itself probably prevented us from asking ourselves the very difficult question, of whether that rating was just or not.

Alex Blumberg: Okay Dave, we just have one final witness for the prosecution. She comes from the one corner of this whole thing that we haven't heard from: the investor.

David Kestenbaum: Mabel Yu, yes, she worked at Vanguard, which manages $400 billion in bond investments. And every time a new structured finance deal came out, these deals, with their triple-A bonds would land on her desk, and on the desks of hundreds of people like her. And those deals looked great to a lot of investors, but they did not look great to Mabel Yu.

> Mabel Yu: I got names of the rating agencies' analysts, and I asked them lots of questions. In the beginning, the questions would be 15 minutes to half an hour, but then it turned into hours and many hours, for me to understand the risk profile of the deal.
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> David Kestenbaum: And what did they say to you?
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> Mabel Yu: I asked them, I said triple-A is supposed to be minimum risk, what triple-A really means, is even if things go bad simultaneously, at the same time, our investors would still be protected. That means if the economy goes down, if the housing price goes down, if interest rates go up, if all those things happen at the same time, what would happen to our investments? And I could not get a straight answer.
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> David Kestenbaum: Did they say, look, you worry too much, we have a lot of smart people working on this?
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> Mabel Yu: Many, many, many, many, many times I felt so dumb many times. And they asked me in many ways, they asked me, don't worry about it have a life. Instead of staying up so late and preparing all those hours of questions for them, just go ahead and enjoy your life. I worry too much. Almost every day. Almost every day? Yes. Yes. Yes.

David Kestenbaum: If you look back what was the thing that was missed?

Tom Warnock: Well, I wouldn't say anything was missed.

Alex Blumberg: And here, at long last is the defendant, or at least an employee of the defendant, Tom Warnock. He actually used to work for Frank Raiter, the guy on the farm, with a turtle. Warnock has been at Standard & Poor's for over 15 years, he's helped make hundreds of mortgage-backed securities and we asked him about Frank Raiter's concerns, that mortgages are being given to the new type of borrower with low credit scores, and little documentation.

Tom Warnock: Never before in the history of the country dating back to the Great Depression, have we had the type of nationwide declines in home prices and the associated default levels.

David Kestenbaum: There are people who would say, these were loans being given to people who didn't even have to prove that they had jobs, we had no data on how these loans were going to perform, how could you rate these things?

Tom Warnock: It's important to understand, the riskier we believes the loan was, the more loss reserves needed to be incorporated into the transaction for us to rate a transaction AAA.

David Kestenbaum: But, there were people who would say you had no data to know what the real risk of those people defaulting was. How could you go and rate something where you didn't have any data on how these loans were going to perform?

Tom Warnock: Well, we had lots of data. We had years worth of data as to how borrowers perform over time.

David Kestenbaum: For these loans, for people who didn't have to prove they had a job? You had lots of data on that?

Tom Warnock: We are able to, through our analytical process, were able to develop assumptions around what we believe the future would be like for these particular borrowers.

David Kestenbaum: Let's examine that last sentence. "We were able to develop assumptions around what the future will be like for these particular borrowers." I think that's one frustration many people have: those are not the words people are looking for. The words people are looking for are these: 'I'm sorry, we were wrong.' Moody's declined our request for interviews, but the president of Standard & Poor's, Deven Sharma did agree to speak with us. Here's the closest he came to admitting that his company screwed up.

> Deven Sharma: Some of our mortgage-related securities experienced more severe downgrades than we have historically experienced, and that's been a disappointment.
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> Alex Blumberg: I think honestly as a listener out there, this is the thing that is frustrating, is that, I've heard this a lot that nobody could have seen this coming, but more than anybody else, that is your job, right? It's the investment bank's job to say, this is going to be great, it's your job to say, you know what, this is how things go bad.
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> Deven Sharma: Our analysts are very smart people, and they do observe that there was too much of a bubble, and we need to do something about it, and they made changes to our methodology and our criteria starting in 2006. Now hindsight, it's like, they didn't make enough of a severe change as we have now experienced. But it's not that they missed it. They missed the severity of it.

David Kestenbaum: Some of you may have detect the delicate verbal parsing of a man who, before our 20-minute interview had probably undergone many hours of legal counseling. The credit-rating agencies are of course being sued, and they don't want to say anything that could be used against them in court. And apparently, listen we screwed up, we're very sorry, can be used against you in court. As a result we'd ask a question, and we'd get a talking point in response.

Alex Blumberg: And so, we find ourselves in a strange position. We've had so many conversations, over beer, over coffee, over the phone with former and current rating agency employees who didn't wish to go on tape. We've read articles, we've sat through panel discussions, and we think we can explain their point of view more clearly than any of their official spokespeople.

David Kestenbaum: Well, we're going to try. So Alex you want to be the rating agency, I'll be the pitbull reporter.

Alex Blumberg: Alright, bring it on man.

David Kestenbaum: Alright, where to start. How about this. When you rate something triple-A, it's supposed to be safe, it's supposed to be really safe, it's supposed to be so safe, that the rating really shouldn't change. And yet nearly half, one-half of the securities you rated triple-A during the bubble, they've been downgraded. Explain that.

Alex Blumberg: Okay, those letter grades, the triple-As and triple-Bs, those are just our best estimates. They're not a buy or sell recommendation. Investors just weren't using our ratings properly. They should have been more like Mabel Yu, asking more questions. They should have come up with their own conclusions.

Besides, it is smart to change the ratings. The economy has fallen off a cliff. You want me to be sure my ratings never go down? Fine. I'll rate anything triple-C. Oh and by the way, we publish all of our models on the internet. You could see how we came up with the rate by yourself if you wanted to.

David Kestenbaum: But what about the fact that you're paid by the people whose securities you were rating.

Alex Blumberg: Sir! The notion that someone could buy a rating from us? You offend me. Look, someone has to pay us. It's either the issuers, or the buyers. There are conflicts of interest either way. We know that, and we deal with it. The vast majority of our ratings held up. We rate trillions of dollars of all kinds of bonds, most of them, have behaved exactly as we expected them. Mortgage-related bonds are a small part of what we do. And anyway, it's totally unfair to put all of this on us. Wall Street and mortgage lenders lied to us, investors got lazy and bought this stuff without doing their own due diligence. You want to know what I think? I think we're a convenient scapegoat, and we're being used by you, and everybody else to avoid examining their own mistakes.

David Kestenbaum: You done?

Alex Blumberg: Yes. It actually felt good to get that off my chest. I'm back now.

David Kestenbaum: Okay, because there's something else we need to talk about, which is the backstory.

Alex Blumberg: Right, the backstory. How did these companies go from publishing their little railroad guides in 1917, to being at the center of a global financial meltdown?

David Kestenbaum: To find the answer, we talked to a professor at NYU named Larry White. And when we say professor, we mean the whole package: gray, slightly-unkempt hair, a novelty tie featuring Nasdaq ticker symbols. And one of the many books in his office, Larry White is sure there is the name of the man who planted the seeds of our current crisis.

> Larry White: Ah, the Comptroller, the Comptroller of the currency, is this Gene White's book? J.F.T. O'Connor, Comptroller 33-38 he is your man. J.F.T. O'Conner he's your man.

David Kestenbaum: Our man J.F.T. O'Connor was Franklin Delano Roosevelt's Comptroller of the Currency at the height of the Great Depression. During the Depression it was O'Connor's job to fix the banking system. And he did what seemed like a totally reasonable, and prudent thing: to try and keep the banks from taking too many risks.

> Larry White: In 1936, the Comptroller of the Currency, tells the banks, that they cannot hold bonds that are below investment grade. Investment grade as determined by whom? By a handful of rating agencies. Perfectly good reasoning, certainly a sensible goal. But what it did was send us down this road of vesting the judgments of these handful of rating agencies with the force of law.

Alex Blumberg: This says the professor, was a pivotal moment, because now those little letter grades took on a special meaning. Whereas before, the rating was just a tool for investors to use, now the rating became a requirement. And things didn't just end there. In 1975 the SEC, the Securities and Exchange Commission, passed a rule saying financial institutions couldn't rely on the ratings of just any agency, but only on specially designated ones. For many years, that meant just three, Moody's, Standard & Poor's and Fitch. States jumped on the bandwagon, and started concern requiring ratings for pension fund investments, and for insurance companies. Even the financial industry got involved, and wrote ratings requirements into it's own deals.

David Kestenbaum: So these three companies, and their letter grades became the foundation for trillions of dollars of investments. It was as if, without fully realizing it, the world had wired the global economy with explosives, and the ratings were the fuse. And then, on July 10th, 2007, the first fuses got lit. Moody's saw the light, and downgraded hundreds of subprime bonds. Standard & Poor's said it would too.

> CLIP 6: In a press release issued not long ago, Moody's says it has downgraded 399 residential mortgage-backed securities, and placed an additional 32 under review for possible downgrades…

Alex Blumberg: As it was happening on TV, it didn't seem like that big a deal. This after all was the summer of '07. The Dow was near its all-time high. The recession had not yet begun. This announcement by Moody's got a mention in the Business section of *The New York Times*. But the front page featured the headline, "Can't Sell Your Home, Maybe It's Priced Too Low." Jerry Fons was inside Moody's at the time.

> Jerry Fons: Really, internally, it was, not much hay was made of it. It was kind of you know, the model shows these were a little weak, and so we see now, there's some deterioration here, and so we're going to lower them. I was done very matter-of-factly. What they couldn't see was that the wheels were really coming off, big-time.

> Jim Finkel: I really do remember what I call the chainsaw massacre.

David Kestenbaum: Jim Finkel, as you can here, saw the downgrades a little differently. Finkel, remember, is the Wall Street structured-finance guy. He'd spent the last few years creating and managing and investing his own money in CDOs, which were made up of lots of bonds, many of which were now been downgraded. He could see things were going to spread, and watching those rating downgrades, Jim said the room was silent. The phones weren't ringing. Everyone was watching the same thing.

> Jim Finkel: I remember it being a hot, summer day. I remember sitting in the office, watching the screens, and the way the screens work was, the individual securities being downgraded come over, line by line. You forgot how many securities that were out there, let alone how many could get downgraded all in one day. And it was just wave after wave after wave of bad information, and it's like body blows. I just felt hollow and helpless. And it was actually quite hard to absorb all the implications. We knew there was an implication to it, but we actually were having a hard time conceptualizing the magnitude of implication, of those ratings, and how systemic this would roll out to be. So the world shaking under your feet wasn't really quiet the metaphor I'd use, it was more some kind of whispering death wind, blowing through the room.

Alex Blumberg: Over the next year and a half, that death wind grew louder. Those first downgrades were followed by more downgrades, of higher and higher rated bonds. And remember, a lot of financial institutions were required by law to hold bonds that were above a certain rating. Now, they had to sell. And because they were all selling at the same time, prices dropped. These dropping prices destabilized the banks which held these bonds: CitiBank, Merrill Lynch, Lehman Brothers, among others. Eventually, it made its way to AIG.

> CLIP 7: We're back everybody, we have more news of course on AIG. Moody's has now downgraded AIG, as well. I want to give you more details there. Those downgrades will have the effect of triggering certain things for AIG…
>
> Jerry Fons: They gained the power that they really didn't want to have.

David Kestenbaum: Jerry Fons, the manager at Moody's.

> Jerry Fons: Whether or not you really are a single-A, if Moody's says you are, you are. And as soon as they downgrade you, you're going to be bankrupt.
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> Alex Blumberg: So basically, the rating agencies were given all this power that all of a sudden you didn't even, in the beginning you didn't even know, it sort of came later, all of a sudden your rating has this market force that if you change it, it's much more than just changing the rating on a single company. The whole system collapses, basically.

Jerry Fons: That's right.

TAPE: What could be done in the future? I think, I think we have to rethink the whole business. From ground up, I think it's broken. I think the way people have relied on ratings has contributed to their downfall. We've just got to move away from this dependence on two or three big companies to do all your work for you.

Alex Blumberg: The rating agencies, on their own, certainly didn't cause all our economic problems. There's plenty of blame to go around for that. But on their way up, they helped inflate the housing bubble. And on the way down, they were sometimes holding the pin to pop it.

David Kestenbaum: They're all kinds of proposals on the table for how, in Jerry Fons' words to rethink the whole business. One idea is that bondholders should get a kind of skeptical second opinion from a rating agency paid by investors. Another would set up a system to reward agencies that get the ratings right. Another idea, get ratings out of regulations completely.

Alex Blumberg: The two biggest rating agencies by the way, Moody's and Standard & Poor's, will be more than willing to do that, would be willing to give up their special legal status. The world may see them as watchmen, as the people who could've stopped this global crisis. But they don't see themselves that way, or at least they don't want to anymore. It's nice to get all the business. It's not so nice to get all the blame.

CREDITS

Ira Glass: Alex Blumberg is one of the producers of the show. David Kestenbaum is a correspondent for NPR News, and if you like what you heard David and Alex and Chana, actually in fact, do a blog and a thrice weekly podcast that is a co-production between our program and NPR News called *Planet Money*. www.npr.org/money. Well our program was produced today by Alex Blumberg and myself, with Jane Feltes, Sarah Koenig, Lisa Pollak, Alissa Shipp, and Nancy Updike. Our Senior Producer is Julie Snyder. Production help from Andi Dixon. Seth Lind is our Production Manager. Music help by Jessica Hopper. Thanks today to Frederic Vignerone of Asset Backed Consulting and Uri Berliner and Adam Davidson. Archival sound courtesy of the WPA Film Library. *This American Life* is distributed by Public Radio International. WBEZ Management Oversight for our show by our boss, Mr. Torey Malatia, who just got back from his vacation in Greece. He had trouble getting around. He says the signage was really weird.

TAPE: It looked like a lot of Greek letters…

Ira Glass: I'm Ira Glass, back next week with more stories of *This American Life*.