



Episode 783: Did Crazy Financial Instruments Bring Down the Economy?

Guest: Ed Stringham

WOODS: Great to have you back. I just stumbled up on this paper of yours I just told people about; I'm linking to it on the show notes page, which is TomWoods.com/783, so people can read it for themselves. But it's about the crisis of 2008. And if you ask me, even though that's eight years ago, as we record this, you can't talk about this stuff too much, because people all ready by and large, despite our best efforts, got the wrong message from that episode, and that means that in the future they're going to do the wrong thing when the same kind of thing happens again. We've got to get this thing straight. Let's start off by having you explain what the mainstream explanation of the events of 2008, or in particular, the explanation of how certain financial instruments performed and so on. What's the mainstream account of that that you are then going to challenge in this paper?

STRINGHAM: Okay, thanks. Yeah, so the standard view is that Wall Street created the economic crisis, specifically advanced derivatives and advanced securities, such as credit default swaps, mortgage-backed securities, collateralized debt obligations. So a lot of people look at the market, they look at Wall Street, and they say, Ah, financial innovation occurred. Then they look at problems that manifested in society, and they say, See? Wall Street created it. The market created it. So there's a lot of finger-pointing done by politicians to look at the private sector, to look at financial intermediation, and to lay the blame on them rather than – and we'll get to this in a second – looking at themselves in the mirror and saying, Did government have anything to do with this at all?

WOODS: All right, you mentioned collateralized debt obligations and mortgage-backed securities. I bet some people know what mortgage-backed securities are, but I also bet a lot of people treat it the way I treated the conflict in Bosnia in the mid 1990s.

STRINGHAM: (laughing)

WOODS: I was in graduate school. I had no idea what was going on, and I figured someday I'll get around to figuring all this out. I'll bet a lot of people feel that way about these things. Can you explain what they are?

STRINGHAM: Sure, so even a lot of free market people, well, they haven't studied it, and some of them say, well, something must be fishing going on; there must be some conspiracy with government. And I actually disagree with that whole narrative, which is really advanced by more like the Occupy Wall Street types, where these things are

fake; they're some type of scam. I think they're legitimate financial innovations, and I'll talk about each of them.

Mortgage-backed security is the simplest to think about in terms of; similar to a mutual fund, where a mutual fund takes 100 companies, puts it together, and says you can buy this security, which is not going to have one stock in it, but it's going to have 100 stocks in it. A mortgage-backed security will take 100 loans and put them together and then sell them to an investor, who then says, Okay, you know what? If one of these loans defaults or five of them default, I still have 99 left, or I still have 95 left. So it's basically a way of allowing people to extend credit to 100 people who want to take out a mortgage without requiring people to put all of their eggs in one basket.

So this is just simply a way of diversifying risk. And we can talk about this in a few minutes. Just because people invest in a company or invest in a mutual fund, it's not a guaranteed success. And same thing with investments in mortgage-backed securities. If the loans that people are making are bad loans, then it's not a guarantee of success. But in and of itself, the invention of a mortgage-backed security is an amazing innovation. It expands the amount of loans available. It diversifies risk among many people. So that's the first one that's fairly straightforward, which I think is great.

The next one we can talk about is credit default swaps, and this one is also talked about very negatively in the press. A lot of people call it the bet that blew up Wall Street, and Warren Buffet, other people, refer to these things as weapons of mass destruction. And I think too here they're actually very unfairly maligned, and I think they are a brilliant market innovation. And they're not technically insurance, but let's just think about these things as insurance.

So suppose I own a mortgage – that I've lent some money to someone – but I'm worried that this person might default. Or suppose I've lent money to a corporation in the terms of a bond or any other loan, and I'm worried that that corporation might default. Well, I have to assume that counter party default risk for this loan that I've given out. Now, one way I can mitigate that risk is I could go to a third party, someone who's selling insurance, someone who's selling credit default swaps, who says, You know what? If this party defaults, do you think that you could insure this loan? And so that's a further step of mitigating risk. And now basically as you take out this insurance policy, you are now mitigating risk against the risk of default.

Now, a further step that people can do, you still have to assume that your insurance company, or in this case the rider of the credit default swap, is going to pay. What if you have a policy and the insurance company says, Oh, you know what? I don't have any money. And so people actually would take out insurance against the insurance company. So that is adding another level of protection. And so in this market, you had various levels of protection. In many cases people would require these riders of insurance, the riders of the credit default swap, to put collateral aside to say, in the event of default, we will pay back, and we've even put this money in an entity which is already there, so you are assured that you're going to get payment. So I think all of this is amazing. It's just like the insurance market.

Now, given that there's insurance, it doesn't mean insurance is going to eliminate disease. It doesn't mean insurance is going to eliminate storms or floods or any other

thing. And what happened in the market was a lot of the underlying securities turned out worse than people had predicted. Some of these mortgages turned out to be less safe than people predicted, and in these cases, people actually had to go to the sellers of the credit default swaps to say, Would you pay me? But that's not a failure of the insurance market; it's just an existence of underlying problems in the economy.

I'm going to mention a huge set of credit default swaps, which functioned in an amazing way. So Fannie Mae and Freddie Mac were nationalized, and in the contracts for these credit default swaps, it said that would count as a credit event. So any time somebody owns bonds by Fannie Mae or Freddie Mac, they're then entitled to this insurance. Well, it turns out there's trillions of dollars of these contracts with this reference. And people said, What are we going to do? How are we going to have these huge pay ups?

Well, it turns out there's a private association called ISDA, the International Swaps and Derivatives Association, and they basically figure out the value of the loans and default; they then figure out how much you're owed, so if your bond is supposed to be worth 100 cents, it's only worth 80 cents, well, now you're owed 20 cents. So they had this netting process and this huge amount of payment, and it all worked quite smoothly. So a lot of these things that people say – Oh, it didn't work; it blew up – I actually argue it made problems a lot less worse than they otherwise would have been.

WOODS: Well, I think you're right about the mortgage-backed security thing. The problem doesn't seem to have been with the instruments themselves so much as it was with the ratings. If people are told that they're AAA-rated, then they're going to have a certain assessment of the risk involved. But there was such a systemic overestimation of the value of these things that it seems hard to exonerate the private sector of major, major oversight or miscalculation. So how do you answer that?

STRINGHAM: I'm actually even going to slightly disagree with you here, Tom, so –

WOODS: Oh, please do.

STRINGHAM: Yeah. So I do agree that investors misestimated future profitability of certain instruments, and so part of market is we don't – and part of any market, including government-controlled markets or even centrally planning – is we don't know the future with certainty. So that's just a fact of the world under any imaginable circumstance. When you go back in the olden days and you had small credit union-style loans for mortgages, even then the people cannot predict the future with 100% accuracy. So sometimes they'll say, Oh, well, John Smith looked like a good risk at the time, but I didn't realize he was going to lose his job. Or it turns out that a lot of the farms in the town go belly-up, and people can misestimate risk. So that's just a fact of the world.

In terms of the rating agencies, these rating agencies didn't do a perfect job. So they would say, okay, this one's AAA, and that one's fairly likely to pay back; this one is rated lower, and that's less likely to pay back. And it turns out they were a little too optimistic. However, I'm going to say that they largely were – they were not widely off track. So if you look at the loans that were more likely to be in default, it was the

subprime-rated loans, the subprime-rated mortgage-backed securities, collateralized debt obligations, which we can chat about in a little bit if you want. But the ones where you had AAA-rated mortgages, there were not that many defaults in terms of the economy. They were much more reliable than the subprime ones.

So the people who invested in subprime loans knew what they were getting into. They knew that these were high-risk loans. That's why they had higher interest rates. But if you look at the interest rates for AAA-rated mortgages, they're actually pretty good. So I've got a statistic here: in any given quarter, banks foreclosure starts for prime fixed-rate mortgage comprised only 1% of loans. If you look at prime adjustable-rate mortgages, which are more risky, those are 2% of loans. And then once you start going to subprime mortgages, it goes up to 3%. And then when you get to subprime adjustable, it's like way higher. So the mortgages that were rated to be more safe actually were more safe. So it's not perfect, but just because things turn out a little bit less good than expected, it doesn't mean the market has failed.

WOODS: There are a lot of objections – I want to talk about credit default swaps for a minute, because I'm liable to forget, and this is a key thing. I'll kick myself if I don't ask you. I want to talk about the alleged cascade of failures that can be caused by the existence of credit default swaps. Let's do that after we thank our sponsor.

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All right, let me just read you one sentence here. This is just from an article from 2008. "The over-the-counter credit default swaps market has drawn the world's major financial institutions and others into a tangled web of interconnections, where the failure of any one institution might jeopardize the entire financial system." This is what we heard throughout the period of the financial crisis, that we have institutions that are too big to fail or that there could be systemic risk, there could be a kind of poison, where one failure leads to another failure, which leads to another failure. And they point to credit default swaps as being at the heart of this looming risk over the whole system. What's the logic of that, and do you think there's anything to that case at all?

STRINGHAM: Well, if you look at *The Big Short*, it's like of like part conspiracy theory type of book, and also the movie. I actually liked the movie, even though I think it really misunderstands the financial instruments it's talking about. But at one point in the movie they have this, I forget what the game is, one of these tower puzzles, and if you take the things out from the bottom, every other piece collapses above it. And that's how they portrayed these things. And it's certainly possible that you could arrange a financial instrument that way, but it turns out they design them in probably exactly the opposite way.

So you have basically, if we can talk about in terms of collateralized debt obligations, these are basically combinations of these other instruments we're talking about, like mortgage-backed securities, and they would prioritize the income streams. So there would be one group, the AAA-rated tranche or slice, we might call it, which was basically guaranteed payment first, and then below that there was someone else's guaranteed payment second, and then at the bottom was – actually, we should say at the top – is the people who are called the first-loss tranche. And so the people who

assume the most risk, the people say if there's any problems, we agree to assume the losses first. And it's only at the very, very end do the safest tranches assume those losses. So that's actually quite the opposite of the description you're talking about. I know the quote is about credit default swaps, and I'll get to that in one second, but a lot of these things were designed in such a way to actually mitigate these problems.

To get to the example of credit default swaps, the prudent firms – And I think Goldman Sachs, there's a lot of good reasons to criticize them for certain things they do with government, but I will praise them for the good things they did here. They were very prudent, in terms of buying credit default swaps from many firms, including AIG, which historically was just a traditional insurance company that started selling these credit default swaps, the equivalent of insurance. And they not only bought some from AIG, but they made sure that they didn't put all of their eggs in one basket. So they bought credit default swaps from multiple companies, so they didn't have too much exposure to AIG or any one other firm. They also required a huge amount of collateral. I think, say, of the 10 billion in credit default swaps they had insured by AIG, they required AIG to put aside 7.5 billion in collateral. So even if AIG had gone bankrupt, which it didn't, firms like Goldman Sachs would have been in an okay situation. They also had bought insurance, the equivalent of insurance, against AIG in case AIG fell.

So the idea that firms' fates are interconnected, there's some truth to that. I totally get that and agree with that. But proper financial risk management means not putting too many of your eggs in one basket. If you are worried that AIG is not going to be able to repay your insurance, you can require collateral. In many cases, firms waived the collateral requirements. They said, Oh, you know, AIG, you're good for it; you've got a AAA rating; don't worry about it. But those were risks that people were willing to assume. So I just totally reject this whole notion that it's like a house of cards; you pull out the bottom card and then everything collapses.

WOODS: Let me read you a passage from Peter Wallison over at AEI – he's really pretty good on this stuff – just to get your comment. He writes – just talking about the specific – not an abstract thought, but a specific case of what actually happened. He says:

"Even Lehman's credit default swap obligations, and the credit default swaps written specifically on Lehman by others, did not cause any substantial disruption in the CDS market when Lehman collapsed. Within a month after the bankruptcy, all of the CDSs specifically written on Lehman were settled through the exchange of approximately \$6 billion among hundreds of counter-parties, and while Lehman had over nine hundred thousand derivatives contracts outstanding at the time it filed for bankruptcy, these did not give rise to any known insolvency among those of its counter-parties that were protected by a Lehman CDS. In cases where Lehman's derivatives counter-parties suffered losses, the counter-parties filed appropriate claims in the Lehman bankruptcy proceeding, which are being adjudicated in the ordinary course. In other words, Lehman-a larger firm than Bear Stearns, which was bailed out, and one that had more 'interconnections,' had no significant effect in dragging down its counter-parties. If Lehman's interconnections did not drag down its counter-parties, Bear's certainly would not have done so."

I assume you agree with that passage?

STRINGHAM: Oh, it's brilliant. I mean, it's really amazing if you think about the levels of complexity of these things, and you mentioned hundreds of counter-parties, so many people involved, how are you going to net these things. And in the olden days, we hear these stories of like, okay, there's going to be a run on the bank, and the first people are going to get these things first, and then that's going to cause everybody to go in. And I'm sure there were examples of this not working out for many people.

But in this market, if they can wind these things down in such an orderly fashion, when you have a group like ISDA overseeing the process to make sure that it's orderly, to say, okay, we're going to figure out who owes what, and we're going to net these things, and then once we figure out the value of who knows what, then we can ask people who are involved with the system to start doing payouts.

So within this market, you can make a contract over an exchange; that's one option. Basically you're dealing with a clearing house, like the Chicago Mercantile Exchange. And in those cases, exchanges are very good at managing counter-party default risk, making sure people get paid what they're owed. But miraculously, even with contract which are made not over an exchange, which are called over-the-counter contracts, so just bilaterally between two people, even though you've got this very complicated network of those things, the fact that those things worked nearly as well as they did in this Lehman example, I think we should all be jumping up and down and celebrating Wall Street and having a parade for Wall Street.

WOODS: Well, that's not a very popular position to take, Ed Stringham.

STRINGHAM: (laughing)

WOODS: Just thought I'd let you know that. Well, what about —

STRINGHAM: I'm the official anti-spokesman for the — I'm the anti-Occupy Wall Street movement.

WOODS: Yeah, there you go. Well, in the wake of the crisis, of course, the usual sort of people were scrambling around, trying to figure out how to regulate the system better, so as to prevent this type of crisis in the future. And it's your contention that — and I know this is a shock to a lot of people listening — that regulation sometimes can do more harm than good.

STRINGHAM: Ha, yeah.

WOODS: So can you elaborate on that? Now, I'm going to be talking to Peter Wallison. He wrote a book on Dodd-Frank, by the way —

STRINGHAM: Oh no.

WOODS: It's a collection of his academic papers, but it's like 600 pages long on Dodd-Frank. So instead of — Don't tell him I said it this way, but instead of having

my listeners try to read 600 pages, I'm going to have him on two days from now to talk to him for half an hour. I think that should do it on that subject. So you don't have to go into too much detail on Dodd-Frank, but in general, the urge for more regulation in the wake of the crisis, what do you think the upshot of that was?

STRINGHAM: So Dodd-Frank right now is, the stuff associated with it, it's not even completely finished being written. You've created tons of small regulator sub-bodies that have to fill in the details. But at present, it's 25 times longer than *War and Peace*, and I just finished *War and Peace*, and it was the best. But imagine 25 of those, not written by Tolstoy, but written by random, unelected bureaucrats. And imagine the amount of constraints that's going to put on the banking industry. And so it turns out that regulations are extremely onerous. They're extremely costly. They are basically trying to micromanage the way that financial firms interact with each other. It's adding a tremendous amount of cost to the system.

And unfortunately, I was predicting this was going to happen a long time ago, that – Actually even when they did the Sarbanes-Oxley Act, people said, Ah, you know what? Enron, Enron. All we need to do is have this huge set of regulations called Sarbanes-Oxley, and then that will solve all our problems moving forward. And I predicted, which is not a very hard prediction to do, that no matter how many regulations they add in Sarbanes-Oxley, it's not going to predict the next set of problems. And it turns out we have our next set of problems, and they said, Ah! The problem was we didn't have enough regulation. All we need to do is have more next time. And I can predict now, this is what I'm 100% sure on, there's going to be some problems in the future, whether it's government-created or just a natural market change in prices, and people will say, Ah! See? It's because we didn't have any regulation. We just need to have Dodd-Frank times 25.

And so the more regulations you add to the economy, the less able banks are able to actually make choices based on assessment of risk and letting different banks assess risk in the way is most proper. Instead you've got government mandating that banks assume risk in certain ways, value risk in certain ways, which, if anything, is going to increase systemic risk in the system when all banks are having to follow a certain set of government rules and regulations. And I think we could see this coming, unfortunately, where you've got politicians saying, You know what? We are going to rein in Wall Street. Well, when you have a bunch of bad news coming – the bad news which I'm calling future Dodd-Frank – that itself is actually going to depress stock markets. That's going to depress financial markets. When these people realize they're going to be hammered by a future set of bad regulations, that actually will go and be priced in to current financial market prices.

So I actually think the economic downturn was caused by multiple factors, set off in large part by monetary factors – which one of my favorite books, it's called *Meltdown* by Tom Woods –

WOODS: How about that? Yeah.

STRINGHAM: And then you add on top of that this prospect of very harmful regulations, then it's no wonder that the financial markets are going to get hammered. It's like, all right, government destabilized us to begin with, and now we can't actually

start sorting things out in a reasonable way. We've got to be dealing with tons and tons of onerous regulations. That's going to actually bring down markets, not help them.

WOODS: What would you say then to somebody who says, All right, Mr. Smart Guy, is your approach then to say that we don't need any regulation of Wall Street whatsoever?

STRINGHAM: Yeah, so historically I think the better solution than government regulation is private regulation, which I will call private governance, private rules and regulations that come through private entities, through things like the New York Stock Exchange, which historically was — it still does a lot of private self-regulation, but it had a much greater role before the creation of the Securities and Exchange Commission. It had listing requirements; it had disclosure requirements; it had membership requirements for brokers, traders, all that stuff. NASDAQ was a competing self-regulatory organization. Today we have the New York Mercantile Exchange, the Chicago Mercantile Exchange. And if you want to opt into a more privately regulated market, you can. If you want to opt out to a less regulated market, so things like the pink sheets or any type of unlisted firm, you can. But the advantage of market regulation, of private regulation, of private governance, is you let the investor opt in.

So I'll give you a cool example. With the hedge fund industry you've got basically a set of funds, which are similar to mutual funds, but they don't have to follow most of the mutual fund rules, so it's basically a completely unregulated market for the most part. And you need to figure out whether your money manager is doing what he's saying he is. And we see cases like, unfortunately, Ponzi schemes, like Bernie Madoff, where he says everything's great, and then investors say, Where's my money? And he says, Trust me; don't worry about it. Well, most investors don't do that. Most investors who are investing in these "unregulated markets" demand private third party certification, custodian services.

So you've got a system of private regulation that's verifying whether there's money in that account. In many cases, the hedge fund manager doesn't even have control of the funds. Those funds might be sitting in an account of, I don't know, JP Morgan, for example. And so your hedge fund manager might say, I'm going to abscond with all this money, but he can't, because you've got a system of private rules and regulations to actually provide assurances to investors. So this is the alternative, is not no regulation, but private regulation, effective private regulations that make markets work.

WOODS: You know, I happen to know a guy who has a book on how private regulations and private agreements can manage a whole lot of difficult topics, and he's known as —

STRINGHAM: It sounds amazing. Do you have any insight?

WOODS: (laughing) Yeah, I know a little something about it. It's called *Private Governance*, and it's by this guy, Ed Stringham —

STRINGHAM: Ahh.

WOODS: – who, as it turns out, I found out today, Ed Stringham is a fan of one of my books.

STRINGHAM: (laughing)

WOODS: So can you take a minute and say a little something about *Private Governance*?

STRINGHAM: Thanks, Tom, I love you. I do love *Meltdown* as well. But *Private Governance* is my book that came out with Oxford University Press, and I basically go throughout history and focus on some modern examples, but a lot of historical examples as well, and look at the emergence of the first stock markets in Amsterdam 400 years ago, England 300 years ago, New York 200 years ago. Most people have this basically fictional belief that you need government to create the rules of the market, you need government to come in and say, Here's how we're going to enforce contracts, and only after government creates the rule of the game, only after government creates the framework will you see the markets emerge.

Well, it turns out that is not the case at all. Markets emerge in what we might call a spontaneous way. There's individual actors making choices at all stages of the game, but it's not being planned by the government; it's being planned by various private parties. And you can actually read what they're doing, the challenges that they faced. And a lot of them said at the time, Government rules are inadequate to deal with these complex markets, so we're going to create a system of private rules to deal with defaulters; we're going to create a system of private rules to deal with fraud and try and protect people from bad action.

And this is not just a small set of markets that happened for a year or two. This happened for hundreds of years. Government wasn't enforcing contracts in the early stock markets, so instead we have private rules and regulations, private governance creating modern society, creating modern capitalism without the hand of the Dodd-Franks or the Elizabeth Warrens of the day.

WOODS: Well, the book is *Private Governance*. What's the subtitle?

STRINGHAM: *Creating Order in Economic and Social Life*.

WOODS: That is awesome. All right, so that's also linked at TomWoods.com/783, so that book and the paper we've been discussing are there, so you can get more detail on these topics. But I'm glad we hit on this, because I know I've kind of indirectly covered this stuff in the past, probably not as systematically as we did today. So thanks for doing that, and we've got to talk to you again soon.

STRINGHAM: Tom, thanks so much. I really enjoyed it.