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I Saw the Crisis Coming. Why Didn't the Fed?

By MICHAEL J. BURRY APRIL 3, 2010

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ALAN GREENSPAN, the former chairman of the Federal Reserve, proclaimed last month that [no one could have predicted the housing bubble](#). “Everybody missed it,” he said, “academia, the Federal Reserve, all regulators.”

But that is not how I remember it. Back in 2005 and 2006, I argued as forcefully as I could, in letters to clients of my investment firm, Scion Capital, that the mortgage market would melt down in the second half of 2007, causing substantial damage to the economy. My prediction was based on my research into the residential mortgage market and mortgage-backed securities. After studying the regulatory filings related to those securities, I waited for the lenders to offer the most risky mortgages conceivable to the least qualified buyers. I knew that would mark the beginning of the end of the housing bubble; it would mean that prices had risen — with the expansion of easy mortgage lending — as high as they could go.

I had begun to worry about the housing market back in 2003, when lenders first resurrected interest-only mortgages, loosening their credit standards to generate a greater volume of loans. Throughout 2004, I had watched as these mortgages were offered to more and more subprime

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borrowers — those with the weakest credit. The lenders generally then sold these risky loans to Wall Street to be packaged into mortgage-backed securities, thus passing along most of the risk. Increasingly, lenders concerned themselves more with the quantity of mortgages they sold than with their quality.

Meanwhile, home buyers, convinced by recent history that real estate prices would always rise, readily signed onto whatever mortgage would get them the biggest house. The incentive for fraud was great: the F.B.I. reported that its mortgage fraud caseload increased fivefold from 2001 to 2004.

At the same time, I also watched how ratings agencies vouched for subprime mortgage-backed securities. To me, these agencies seemed not to be paying much attention.

By mid-2005, I had so much confidence in my analysis that I staked my reputation on it. That is, I purchased credit default swaps — a type of insurance — on billions of dollars worth of both subprime mortgage-backed securities and the bonds of many of the financial companies that would be devastated when the real estate bubble burst. As the value of the bonds fell, the value of the credit default swaps would rise. Our swaps covered many of the firms that failed or nearly failed, including the insurer American International Group and the mortgage lenders Fannie Mae and Freddie Mac.

I entered these trades carefully. Suspecting that my Wall Street counterparties might not be able or willing to pay up when the time came, I used six counterparties to minimize my exposure to any one of them. I also specifically avoided using Lehman Brothers and Bear Stearns as counterparties, as I viewed both to be mortally exposed to the crisis I foresaw.

What's more, I demanded daily collateral settlement — if positions moved in our favor, I wanted cash posted to our account the next day. This was something I knew that Goldman Sachs and other derivatives dealers did not demand of AAA-rated A.I.G.

I believed that the collapse of the subprime mortgage market would ultimately lead to huge failures among the largest financial institutions. But at the time almost no one else thought these trades would work out in my favor.



Alex
Nabaum

During 2007, under constant pressure from my investors, I liquidated most of our credit default swaps at a substantial profit. By early 2008, I feared the effects of government intervention and exited all our remaining credit default positions — by auctioning them to the many Wall Street banks that were themselves by then desperate to buy protection against default. This was well in advance of the government bailouts. Because I had been operating in the face of strong opposition from both my investors and the Wall Street community, it took everything I had to see these trades through to completion. Disheartened on many fronts, I shut down Scion Capital in 2008.

Since then, I have often wondered why nobody in Washington showed any interest in hearing exactly how I arrived at my conclusions that the housing bubble would burst when it did and that it could cripple the big financial institutions. A week ago I learned the answer when Al Hunt of Bloomberg Television, who had read Michael Lewis's book, "The Big Short," which includes the story of my predictions, asked Mr. Greenspan directly. The former Fed chairman responded that my insights had been a "statistical illusion." Perhaps, he suggested, I was just a supremely lucky flipper of coins.

Mr. Greenspan said that he sat through innumerable meetings at the Fed with crack economists, and not one of them warned of the problems that were to come. By Mr. Greenspan's logic, anyone who

might have foreseen the housing bubble would have been invited into the ivory tower, so if all those who were there did not hear it, then no one could have said it.

As a nation, we cannot afford to live with Mr. Greenspan's way of thinking. The truth is, he should have seen what was coming and offered a sober, apolitical warning. Everyone would have listened; when he talked about the economy, the world hung on every single word.

Unfortunately, he did not give good advice. In February 2004, a few months before the Fed formally ended a remarkable streak of interest-rate cuts, Mr. Greenspan told Americans that they would be missing out if they failed to take advantage of cost-saving adjustable-rate mortgages. And he suggested to the banks that "[American consumers might benefit if lenders provided greater mortgage product alternatives](#) to the traditional fixed-rate mortgage."

Within a year lenders made interest-only adjustable-rate mortgages readily available to subprime borrowers. And within 18 months lenders offered subprime borrowers so-called pay-option adjustable-rate mortgages, which allowed borrowers to make partial monthly payments and have the remainder added to the loan balance (much like payments on a credit card).

Observing these trends in April 2005, Mr. Greenspan [trumpeted the expansion of the subprime mortgage market](#). "Where once more-marginal applicants would simply have been denied credit," he said, "lenders are now able to quite efficiently judge the risk posed by individual applicants and to price that risk appropriately."

Yet the tide was about to turn. By December 2005, subprime mortgages that had been issued just six months earlier were already showing atypically high delinquency rates. (It's worth noting that even though most of these mortgages had a low two-year teaser rate, the borrowers still had early difficulty making payments.)

The market for subprime mortgages and the derivatives thereof would not begin its spectacular collapse until roughly two years after Mr. Greenspan's speech. But the signs were all there in 2005, when a bursting of the bubble would have had far less dire consequences, and when the government could have acted to minimize the fallout.

Instead, our leaders in Washington either willfully or ignorantly aided and abetted the bubble. And even when the full extent of the financial

crisis became painfully clear early in 2007, the Federal Reserve chairman, the Treasury secretary, the president and senior members of Congress repeatedly underestimated the severity of the problem, ultimately leaving themselves with only one policy tool — the epic and unfair taxpayer-financed bailouts. Now, in exchange for that extra year or two of consumer bliss we all enjoyed, our children and our children's children will suffer terrible financial consequences.

It did not have to be this way. And at this point there is no reason to reflexively dismiss the analysis of those who foresaw the crisis. Mr. Greenspan should use his substantial intellect and unsurpassed knowledge of government to ascertain and explain exactly how he and other officials missed the boat. If the mistakes were properly outlined, that might both inform Congress's efforts to improve financial regulation and help keep future Fed chairmen from making the same errors again.

Michael J. Burry ran the hedge fund Scion Capital from 2000 until 2008.

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