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We Are All Ignorant

Jesse Walker | February 18, 2010

Over at *Cato Policy Report*, Jeffrey Friedman offers a sharp argument about the causes of the economic crisis. The article is notable for the stress it puts on the influence of *ignorance* -- not as a problem to be solved, but as an unavoidable, universal aspect of the human condition. The essay is filled with examples; an excerpt should give you the idea:

> [The Recourse Rule] created a huge artificial demand for mortgage-backed bonds, each of which required thousands of mortgages as collateral. Commercial banks duly met this demand by lowering their lending standards. When many of the same banks traded their mortgages for mortgage-backed bonds to gain "capital relief," they thought they were offloading the riskiest mortgages by buying only triple-A-rated slices of the resulting mortgage pools. The bankers appear to have been ignorant of yet another obscure regulation: a 1975 amendment to the SEC's Net Capital Rule, which turned the three existing rating companies -- S&P, Moody's, and Fitch -- into a legally protected oligopoly. The bankers' ignorance is suggested by e-mails unearthed during the recent trial of Ralph Cioffi and Matthew Tannin, who ran the two Bear Stearns hedge funds that invested heavily in highly rated subprime mortgage-backed bonds. The e-mails show that Tannin was a true believer in the soundness of those ratings; he and his partner were exonerated by the jury on the grounds that the two men were as surprised by the catastrophe as everyone else was. Like everyone else, they trusted S&P, Moody's, and Fitch. But as we would expect of corporations shielded from market competition, these three "rating agencies" had gotten sloppy. Moody's did not update its model of the residential mortgage market after 2002, when the boom was barely underway. And Moody's model, like those of its "competitors," determined how large they could make the AA and AAA slices of mortgage-backed securities.
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> The regulators seem to have been as ignorant of the implications of the relevant regulations as the bankers were. The SEC trusted the three rating agencies to continue their reliable performance even after its own 1975 ruling protected them from the market competition that had made their ratings reliable. Nearly everyone, from Alan Greenspan and Ben Bernanke on down, seemed to be ignorant of the various regulations that were pumping up house prices and pushing down lending standards. And the FDIC, the Fed, the Comptroller of the Currency, and the Office of Thrift Supervision, in promulgating one of those

> regulations, trusted the three rating companies when they decided that these companies' AA and AAA ratings would be the basis of the immense capital relief that the Recourse Rule conferred on investment-bank-issued mortgage-backed securities.

"Omniscience cannot be expected of human beings," Friedman concludes. "One really would have had to be a god to master the millions of pages in the Federal Register -- not to mention the pages of the Register's state, local, and now international counterparts -- so one could pick out the specific group of regulations, issued in different fields over the course of decades, that would end up conspiring to create the greatest banking crisis since the Great Depression. This storm may have been perfect, therefore, but it may not prove to be rare. New regulations are bound to interact unexpectedly with old ones if the regulators, being human, are ignorant of the old ones and of their effects."