Neil FLIGSTEIN, *The Banks Did It: An Anatomy of the Financial Crisis* (Cambridge Mass., Harvard University Press, 2021, 315 p.)

Neil Fligstein has written an eloquently and persuasively argued study of the origins of the 2007–2008 financial crisis, often now known as the "Global Financial Crisis," but also sometimes as the "subprime crisis." What is the most accurate label? Fligstein prefers "financial crisis," but this one was a highly peculiar and idiosyncratic one. Like any complex social process, finding a driver—answering the question who or what did it—is not easy: the answer requires an identification of the problem and its precise institutional and geographical location.

Many people followed German Finance Minister Peer Steinbrück in calling it "above all an American problem." Fligstein largely accepts this view, and he focuses on the subprime issue. Others think of the collapse as a crisis of globalization, driven by the wage effects of the rapid development of emerging markets, largely Asian, but also of global movements in savings and interest rates (what Ben Bernanke called the "savings glut") driven also by emerging markets and especially China.[1]

Some European banks make an appearance in Fligstein's book, but the argument first advanced by Hyun Song Shin of the centrality of the relationship between the European and US financial systems, with European institutions funding themselves on the US money market and then buying securitized US assets, is largely sidestepped.[2] This feature of the institutional setup led Tam Bayoumi to formulate the concept of a North Atlantic crisis, and Fligstein is correct in saying that, unlike the interwar Great Depression, this was *not* a global crisis.[3]

His main argument is specifically US focused. It starts with the familiar story of the gradual erosion of depression-era regulation, in particular of the separation of commercial from investment banking in the 1933 Glass-Steagall Act. The result of deregulation was a reorganization of financial services towards complete vertical integration. There

[1] Remarks by Governor Ben Bernanke at the Sandridge Lecture, Virginia Association of Economists, Richmond, Virginia [March 10, 2005 at https://www.federalreserve.gov/boarddocs/speeches/2005/200503102/].

[2] Hyun SONG SHIN, "Global Banking Glut and Loan Risk Premium," *IMF Jacques Polak Research Conference* [November 10-11, 2011, https://www.imf.org/external/np/res/seminars/2011/arc/pdf/hss.pdf].

[3] Tamim BAYOUMI, 2017, *Unfinished Business: The Unexplored Causes of the Financial Crisis and the Lessons Yet to be Learned* (New Haven, Yale University Press).

Harold JAMES, Princeton University, USA [hjames@princeton.edu].

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is a European dimension here too, which it would have made sense to consider: the large US banks pressing for change could argue that they were being out-competed by European financial conglomerates. Fligstein also neatly tells the story of the development of the mortgage market, from the 1968 Housing and Urban Development Act which reshaped the depression era Fannie Mae as a government-sponsored enterprise (GSE) that would issue bonds to raise private capital to fund private mortgages outside the federal budget, through to the massive problems of savings and loans in the 1980s as Wall Street investment firms bought up securitized mortgages.

The most original suggestion is the account of a development that has puzzled many observers and brought forth an entire range of explanations: the expansion of interbank lending (observable in international as well as US data) in 2004. The data suggests that this was the moment when the bubble that would burst a few years later really developed. One influential interpretation explains it in terms of a change in the Securities and Exchange Commission's leverage rule establishing an alternative net capital calculation method and creating a "consolidated supervised entities" program.[4] The institutional backdrop was also European, a response to a European Union Financial Conglomerates Directive with the requirement that financial institutions doing business in the European Union must have "equivalent supervision." Another influential interpretation thinks of monetary policy that was directed too long against the threat of deflation that appeared in the early years of the new millennium, in the wake of the dotcom crash of 2001. And, of course, it is conceivable that various causal factors interact, as Òscar Jordà, Moritz Schularick and Alan M. Taylor suggest when they consider loose monetary conditions as a key trigger of bubbles and financial stress, with structural changes in finance magnifying that effect.[5]

Fligstein's version focuses on the US housing and mortgage market, the origins of which he carefully and clearly lays out in the early chapters. His new and insightful point is that the mortgage securitization industry which had developed in the 1990s faced a sudden supply crisis in 2004, with monthly origination falling from $200 billion in August 2003 to less than $60 billion one year later. The boom in 2003 was driven largely by the refinancing of existing mortgages, and that simply ran out of steam. Interest rates were also picking up, slightly. But there was a large, almost

[4] For instance, Alan S. Blinder, 2009, "Six Errors on the Path to the Financial Crisis," *The New York Times*, January 24.

[5] Òscar Jordà, Moritz Schularick and Alan M. Taylor, 2015, "Betting the House," *Journal of International Economics*, vol. 96(S1), pages S2–S18.

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insatiable, demand "from investors" [157], and the industry therefore reconfigured itself to fill that demand by generating new mortgages. Banks were thus pushing mortgages in order to continue a lucrative business. Often that approach involved miss-selling: there is an excellent account here of the traps that adjustable rate mortgages presented to customers (not always financially illiterate) who were deceived and misled. Investment banks started aggressively acquiring mortgage originators, so that they would control the entire chain of mortgage production.

Fligstein provides neat case studies of four of the institutions that were at the center of the collapse. Countrywide Financial developed a substantial hold on the business of originating and aggregating conventional mortgages and then selling them on to the GSEs. Bear Stearns was an investment bank that turned itself into a vertically integrated mortgage bank. It was rescued in March 2008 in a government organized operation that immediately led many commentators to reflect that the fundamental operating principles of the capitalist system were being violated. Washington Mutual evolved from a savings and loan bank into a mortgage bank. Finally Citibank, a globally operating commercial bank, remade itself through excursions into consumer credit (the credit card business) and then into mortgages. This was truly a bank that became too big and too systemically important to fail. Institutions that were very different at the outset all came to resemble each other. A key aspect of the new integration of mortgage origination and repackaging and selling was that a series of complex operations was handled internally, and untransparently, by each institution. The pressure to sell particular products affected the way in which the risks involved in the first stages, concluding the mortgages (origination), were assessed. As Fligstein puts it, "vertical integration also increased the likelihood that within the bank, no one had any interest in doing due diligence in value chains." [199].

The second major issue that Fligstein tackles is the responsibility of the Federal Reserve in allowing the explosive bubble to develop. His answer is that the central monetary and the less completely central regulatory institution suffered from group think, or a silo mentality. The dynamic of rather formalistic meetings made it difficult to challenge decisions, and participants downplayed uncomfortable facts and "normalize[d] discordant information." [225] Thus the key decision-making body, the Federal Open Market Committee (FOMC), largely missed the housing bubble. More importantly, policy-makers were too concerned with macroeconomics, with large aggregates on growth, unemployment, productivity and above all price indices, and too little with the precise

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mechanics of financial institutions. "The FOMC failed to see the depth of the problems in the housing and financial sectors because of its over-reliance on macroeconomics as the frame it used for making sense of the economy" [225].

On the other hand, Fligstein correctly gives the Federal Reserve and particularly Chairman Ben Bernanke a good grade for acting decisively to prevent a global meltdown. Perhaps macroeconomics was a better guide to a dramatic collapse in overall demand: the policy recommendations (fiscal action, bank recapitalization, and above all liquidity provision) were the academic answers that Bernanke and his colleagues derived from their study of the Great Depression, but also from the 20 years of post-1991 Japanese stagnation.

The outcome of the financial crisis holds some ironies. Banks became bigger, as a result of strong banks being pushed by government to take over weaker institutions. The government largely took over the mortgage market with the effective nationalization of the GSEs Fannie Mae and Freddie Mac.

It might have been helpful to explore some of the controversial issues surrounding the financial crisis and the official response made. Was bank recapitalization through the Troubled Asset Relief Program (TARP) the appropriate answer? Or would it have been better to do what the TARP, as its name suggests, was originally intended to do: to take troubled assets off bank balance sheets?

What was driving the mortgage securitization mania? Was it, as Fligstein suggests, simply the logic of the structure of the financial industry, with its increasingly comprehensive vertical integration? Or was it the result of pressure by both Democratic (Clinton) and Republican (George W. Bush) administrations to extend homeownership as a way of stabilizing the social fabric of the United States? Ragu Rajan suggested that greater access to credit served as a compensation for the failure of wages to grow (a result in part of globalization and the "China effect," but also of technical change and the "new machine age").[6]

The narrative that the central problem was the growth of subprime lending to poorer Americans, often Hispanics and Blacks, is part of the folklore of the financial crisis. Fligstein seems largely to accept it. It was given some powerful statistical underpinning by work, strangely not cited by Fligstein, by Atif Mian and Amir Sufi on the locations by postal

[6] Raghuram RAJAN, 2011, *Fault Lines: How Hidden Fractures Still Threaten the World Economy* (Princeton, Princeton University Press).

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(zip) code of mortgage growth.[7] More recently, however, that result has been challenged in a series of striking papers by Manuel Adelino, Antoinette Schoar, and Felipe Severino.[8] They provide strong evidence that the greatest growth of mortgage lending was not to poorer income deciles, but to richer Americans. Was the housing mania really an affair of the American middle class and especially of the elite, buying houses in order to flip them in a period of dramatic rises in house prices: an activity that would come unstuck when the prices stopped rising?

It would also have been interesting to undertake a more detailed examination of the approach of macroeconomists, and especially of the Federal Reserve, to the debate as to how far policy should take notice of asset prices as well as of consumer price developments. The prevailing orthodoxy in Washington was that consumer prices were at the center of the Fed's price stability mandate, and that policy would respond to asset price movements only when they affected consumer prices: for instance, if rising house values encouraged homeowners to take credit on the security of their homes, or undertake second mortgages.

The approach to the principle behind monetary policy matters, in that the stabilization policy chosen in responding to the crisis, when monetary policy running into an "effective lower bound" as interest rates were near zero, took the form of asset purchases (so-called Quantitative Easing). There was more "loose monetary policy," and the effect drove up asset prices. So house prices recovered, resuming their upward movement and the national average reached pre-crisis level by 2016. That invites the question of whether there was even a bubble in the first place or whether there was a simple panic. An account by Laurence Ball suggests that Lehman Brothers, the institution at the heart of the September 2008 collapse, was not really insolvent.[9]

At the conclusion of the book, Fligstein holds neoliberal deregulation responsible for the disaster. But it would be worth thinking more about what kind of neoliberalism was involved here. It cannot really be described as a victory of the market, in that the large vertical corporate structures that Fligstein describes are not really market institutions at all. Segmented systems, in which participants are only engaged in one activity—like the classic British system from the middle of the 19th

[7] Atif MIAN and Amir SUFI, 2015, *House of Debt: How They (And You) Caused the Great Recession, And How We Can Prevent It from Happening Again* (Chicago, University of Chicago Press).

[8] Manuel ADELINO, Antoinette SCHOAR and Felipe SEVERINO, *Dynamics of Housing Debt in the Recent Boom and Great Recession*, NBER Working Paper 23502, October 2017.

[9] Laurence M. BALL, 2018, *The Fed and Lehman Brothers: Setting the Record Straight on a Financial Disaster*, Studies in Macroeconomic History (New York, NY, Cambridge University Press).

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century to deregulation and the UK's Big Bang in 1986, are astonishingly stable and do not require much supervision and regulation since the market quickly punishes bad behavior.[10] But the financialization of the 1990s and 2000s had financial actors largely conducting their own transactions internally at prices determined by their proprietary models. The Basel international capital adequacy calculations were even revised so as to allow the use of large banks' own internal risk models. The key concept of capitalism, transparent pricing on a market, was thus broken.

Debate still surrounds the failure of Lehman Brothers, the iconic event of the financial crisis. It occurred over the weekend of September 13-14, 2008, with bankruptcy filed on the Monday morning, September 15. In reality, however, it was a slow-motion collapse: as funding dried up in the preceding week, it was apparent to everyone that Lehman would fail because the other banks had shut it off. On the Monday morning, the major newspapers, both the more free market *Wall Street Journal*, and the more liberal (in an American sense) *New York Times*, welcomed the Fed's and the Treasury's decision to allow an institution to fail. Lehman was after all not a megabank (it was not Citigroup) and markets are supposed to punish bad behavior. It was only when it was clear that the Lehman failure would bring down AIG, a major insurer that was indisputably systemically important, that the authorities believed they were obliged to step in in order to prevent a universal collapse. AIG would surely also have been a desirable subject for a detailed case study.

A complete assessment of the financial crisis should deal with the Global Financial Crisis element (the effect of China on global financial markets, and on the American labor market; the role of large insurers such as AIG) as well as the subprime element. However, Fligstein has delivered a valuable exploration of one piece of the puzzle.

HAROLD JAMES

[10] Anthony C. HOTSON, 2017, *Respectable Banking: The Search for Stability in London's Money and Credit Markets Since 1695* (Cambridge, Cambridge University Press).

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