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Article

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economic sociology_the european electronic newsletter

Provided in Cooperation with:
Max Planck Institute for the Study of Societies (MPIfG), Cologne

Suggested Citation: Fligstein, Neil (2009) : Neil Fligstein answers questions on the present financial crisis, economic sociology_the european electronic newsletter, ISSN 1871-3351, Max Planck Institute for the Study of Societies (MPIfG), Cologne, Vol. 11, Iss. 1, pp. 41-44

This Version is available at:
http://hdl.handle.net/10419/155935

Neil Fligstein Answers Questions on the Present Financial Crisis

How would you say the present crisis is related to the evolution of corporate control that you have studied in one of your previous books?

I want to answer this question in a more general way. I note that economic sociologists did no better at understanding how the American financial sector was building itself up to the current crisis than the economists. I include myself in this regard. This should give us great pause.

Sociologists who have been studying finance for the past 10 years completely missed the forces that produced the ongoing crisis. Their study of trading floors and trading instruments gave them no inkling of what was really going on in the financial world. While they may have caught the flavor of what was going on inside of stock exchanges, they have obviously missed what was really important about finance.

Sociologists who have been studying the globalization of finance did no better. Their critical attitude towards that process has mainly focused on the role of finance in currency exchange, trade, and development. They have only seen this as a kind of integration process where their main idea is that governments have lost control over such markets. But, they obviously have been studying the wrong things as well. This was not a currency crisis or a crisis in trade. It was a crisis in the core way in which banks and other financial organizations made money. No one saw mortgage securitization as one of the real core businesses of this system. No one saw how banks around the world either copied the tactics of the American banks or else bought American mortgage backed securities.

Finally, scholars oriented towards thinking that the world has become one giant network did no better either. Scholars using metaphors such as structural holes, robust action, network society, network organization, and the view that networks produce either information or trust that allows the coordination of new ideas to produce new and successful markets completely missed the growth of the U.S. mortgage securitization sector. That sector grew from a $500 billion business in 1990 to a $4 trillion business in 2003. Not a single one of them studied it.

I am not going to let myself off the hook. I have been focused on how "shareholder value ideology" has affected corporate strategies and structures across Fortune 1000 corporations. I have also been interested in whether such ideas have spread across the world. I have shown how the ideology of shareholder value has allowed top managers to use technology, union busting tactics, and financial engineering to increase profits in the U.S. I have also shown that they used their success to capture so much pay that they have increased income inequality in the U.S. and other societies, such as Great Britain that bought into the U.S. model.

But I missed the rise and dominance of the financial sector in the U.S. that has been going on since the mid 1980s. Almost no one in sociology really caught up to how the financial sector (defined by the industry categories "finance, insurance, real estate") in the U.S. increased its share of overall corporate profits in the country to about 40% with 7% of the labor force and 10% of GDP (for an exception see some of Greta Krippner's recent work).

So, it is possible for me to go back to what I and others have been studying and try and see where we went wrong. But I would have to be generally critical in noting that economic sociology and the parts of it that claim to understand either finance directly or else the study of capitalism did not see this coming.

How do the present crisis and the collapse of major actors of the financial field fit your conception of the architecture of markets?

Having taken us all to task for missing the growth of mortgage securitization and its proliferation of financial instruments, I think the conceptual tools I used in the "Transformation of Corporate Control" and the "Architecture of Markets" remain relevant.

My view of how to study markets focuses on how firms organize particular industries, construct conceptions of control (i.e. ways to make profits and stabilize their relationships to their main competitors), and how this occurs in relation to governments. My view is also dynamic by suggesting that processes that allow new markets to emerge should be studied differently than markets where the players are established and working within a conception of control. New conceptions of control emerge as social movements, result from political coalitions between leading firms, and then spread tactically across the main firms in a market. Established markets are "games" where there is a jockeying for position between market actors who watch one another and respond to challenges and opportunities. The third process to study is the kinds of crises that cause such markets to become completely destabilized, resulting in the destruction of the incumbent firms. Here, the issue is usually how a disruptive shock emerges to put the incumbent firms out of business (an extinction event that occurred in the mortgage securitization business).

My critique of most of the literature on the financial services industry in economic sociology is that it has failed to analyze the fact that firms are the main entities that have organized different financial markets. We have tended to treat the financial sector as if firms (banks and so-called non-bank banks) do not matter and, as a corollary, as if there were only one market. This has led us to study traders and exchanges or instruments and not how the firms who created these products were in fact creating separate markets dominated by separate firms. Moreover, this focus on traders and instruments (with a few exceptions such as Donald MacKenzie's work) caused scholars to miss the role of government. This caused scholars to fail to even consider the importance of the mortgage securitization market, its history, the role of government and firms in pioneering the market, and the subsequent dynamics that produced the steep rise and sudden fall.

As a result, we still do not know why the U.S. subprime market spread across the entire U.S. banking system and how it spread across countries. For me, the most important task is for us to do an autopsy on the industry in order to see its creation, rise, spread and fall. So, for example, my own view, based on preliminary work, is that the banks around the world that fell did so either because they emulated the American banks or because they bought the mortgage backed securities in large numbers.

There are already a set of conventional wisdoms that have evolved out there that either stress the financial instruments themselves or the fact that individual decision makers behaved rationally, but the systemic effect was irrational. Before we accept these views, it is important to analyze what really happened.

I have been trying to do some of this for the past year. I have written a paper on this topic that I would be pleased to share with interested readers. Let me give you the broad outlines of what I have found that are informed by the perspective I have elucidated in my previous work.

First, the mortgage securitization market was created by the American government in the late 1960s. The idea was that the Johnson Administration wanted to increase home ownership. But, they were under great pressure not to start a large government program whereby the government became a large bank holding a large fraction of mortgages in the U.S. They hit on two important ideas. They invented the mortgage backed security. The idea was to make loans, then package mortgages together into bonds, sell the bonds, and then use the funds to make more loans. They created what are called "government sponsored enterprises", Freddie Mac, Fannie Mae, and Ginnie Mae, to package and underwrite mortgage backed securities (MBS).

The first mortgage backed security was issued in 1970. The market for MBS was slow to develop. There were several issues. One was the continued dominance of the savings and loan industry as the provider of mortgages. The others were technical and legal problems with selling MBS. The collapse of the Savings and Loan industry (itself an important and not well studied event) opened up the mortgage market for a new way of funding mortgages. The technical and legal problems were resolved in the mid 1980s in a series of moves that were coordinated across industry and government. Part of this resolution involved the invention of "tranching", the division of these bonds into groups that held different kinds of risk ratings. Here, both government and private banks pioneered these tactics.

From 1990 until 2003, the market expanded dramatically. The market also became quite concentrated. The largest loan originators became national banks, the investment banks grew dramatically, and the three ratings companies found their main market to be the rating of MBS. Moreover, the largest banks originated, packaged, and sold MBS. They also held on to a large number of MBS as investments. I note that there was a financial revolution that extended beyond mortgages. Every form of debt became a focus of securitization and these markets grew from essentially zero in the mid 1980s to over $2.5 trillion by 2006.

The real crisis occurred from 2003-2007. Basically, the overall size of the prime mortgage market peaked in 2003 at nearly $4 trillion. It dropped dramatically to $2.5 trillion in 2004. This means that in order for banks to continue to grow their businesses, they needed to find a new source of mortgages. The market they found was the subprime market. That market grew from being 10% of the overall mortgage market in 2001 to 70% in 2006.

The analysis I have done suggests that three conventional wisdoms about what happened are wrong. The first is that the market was not concentrated. This is not true. Indeed, by 2005, the top 10 firms in each part of the market controlled from 60%-90% of their market. The second is that the financial instruments were responsible for what happened. Given that the instruments helped build the market, it is hard to see how they all of a sudden could have been responsible for the downfall. They were the vehicles by which the market expanded. So, how could they have been the cause of the decline? The cause of the collapse must be sought in terms of something like changed from 2001-2008. What changed was the rapid increase in subprime mortgages. Finally, there is an argument out there that loan originators and packagers did not keep MBS bonds that they knew might be dicey. This is not true. One of the main reasons that so many of the core banks in the market went out of business is that they borrowed money to hold onto subprime MBS and their holdings dramatically increased from 2003-2007.

From the "Architecture of Markets" perspective, the cause of the crisis was the shift towards the subprime market and the role of regulators in allowing this to happen. Understanding this process will give us insight into what happened and what might be done to prevent it. In my analysis, I show that low interest rates pushed firms into borrowing more money. Subprime mortgages were what they borrowed money for. Ratings companies cooperated with packagers of loans by overrating them. When the underlying mortgages began to default, the whole system began to collapse.

In what ways if any, would you say that state intervention differs from what happened during previous major economic crises?

Never in American history has the government intervened in as large a way into one sector of the economy. The savings and loan crisis of the 1980s was a $200 billion affair while the price tag for what the government has done in the past 12 months is over $4 trillion. This is because of the centrality of housing to the US economy. It is not only the largest sector of the economy, but its health is tied to every other aspect of American life.

In the U.S., the government essentially created the mortgage securitization market. They also under wrote much of the market by acting as the conduit through the government sponsored enterprises. The U.S., in this regard, looks like a classic developmental state. The government also encouraged the private sector to enter both the origination and packaging of the MBS markets with the idea that increasing the size of the market would increase rates of home ownership. This also explains why both Republicans and Democrats supported whatever new laws and regulations the banks wanted. Republicans saw it as good for the banking business and Democrats saw it as good for people who wanted to own their own house.

Of course, the government liked to pretend that it was not doing this. So, for example, in the mortgage market, everyone who bought bonds came to assume that the federal government stood behind Freddie Mac, Fannie Mae, and Ginnie Mae. But American politicians, both Republicans and Democrats never acknowledged that this is what they were doing. They maintained the useful fiction that the government sponsored entities were private corporations.

The financial bailout has been carried out in a non-transparent fashion. The firms that went bankrupt were at the core of these markets. Indeed, 7 of the 10 largest loan originators are out of business and 8 of the ten largest issuers of MBS are out of business. The government took over Freddie Mac and Fannie Mae making it the largest holder of MBS in the country. The government functionally is the owner of the two largest bank holding companies, Bank of America and Citibank (and of course they own AIG). The government not only provided capital for the largest banks, but it is currently the only real financial entity that is buying MBS that are currently being issued.

The crisis ended because of the most massive market intervention in economic history. The government has taken over the entire mortgage industry. Ironically, what the Johnson Administration sought to avoid in the 1960s has become reality today. Again, regulators, policymakers and politicians (for political and ideological reasons) continue to pretend that there still exists a market for mortgages and MBS where the government is a minor player. The facts speak otherwise.

What market architecture do you believe will emerge after the present crisis?

There is certainly going to be some changes. Banks around the world will have to hold more capital reserves and if they want to make riskier investments will have to increase those reserves. Regulators will worry about executive compensation, but my guess is that this will prove hard to regulate.

I am actually skeptical that a lot is going to change in the U.S. The banks have so far resisted most of the changes. I am a big fan of the idea of a consumer protection agency for finance. There is certainly evidence that some people who bought subprime mortgages were duped and had there been better regulation, some of this tragedy could have been avoided.

But, the banks hate the idea and are rallying opposition to it. As the crisis recedes into the background, the push for those changes will lessen. It is likely that after almost collapsing the world economy, the remaining banks will pretty much continue business as usual. This is depressing in many ways. The people who are the regulators share decision premises with the bankers. They believe that fundamentally the bankers behaved rationally. They view what happened as an accident. These regulators still think like the bankers do.

Product lines are evaluated on their short-run profitability and important management decisions are based on the potential profitability of each line. Firms are viewed as collections of assets earning differing rates of return, not as producers of given goods. The firm is not seen as being a member of only one industry.Â â€" Neil Fligstein American sociologist 1951 The transformation of corporate control, 1993, p. 117. recommended by Neil Fligstein. The Architecture of Markets by Neil Fligstein. Read. It's important to understand social aspects of economic behaviour, particularly when times of crisis reveal the shortcomings of traditional economic theory, says sociologist Neil Fligstein. Interview by Eve Gerber. The Architecture of Markets by Neil Fligstein. Read. Buy all books.