Book Fool's Gold

How the Bold Dream of a Small Tribe at J.P. Morgan Was Corrupted by Wall Street Greed and Unleashed a Catastrophe

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Free Press, 2009

Recommendation

This ranks as one of the most thorough, accessible explanations of how the global financial system nearly disintegrated during the great financial crisis that broke in 2008. Gillian Tett traces the development of credit derivatives from their inception at an alcohol-fueled Boca Raton corporate retreat in the early 1990s. She shows how the pioneers struggled with risk management, turning down business that other financial institutions with less regard to risk sought eagerly. She elucidates the building and breaking of the wave of institutional crises – Bear Stearns, Lehman, AIG – during 2007 and 2008, and takes readers inside tense meetings between bankers and regulators at the New York Federal Reserve and the U.S. Treasury. This is capital financial journalism, which *BooksInShort* highly recommends to any reader who hopes to get a better understanding of the forces at work in the financial crisis.

Take-Aways

- J.P. Morgan bankers pioneered credit derivatives, but used them cautiously.
- Other banks took risks Morgan's experts found imprudent and intolerable.
- J.P. Morgan's revenue and stock price suffered in comparison to its peers' results, but CEO Jamie Dimon refused to let it run with the risk-chasing herd.
- The growth of the credit derivatives market, especially combined with mortgage securitization, created many poorly understood links among financial institutions.
- The pioneers of derivatives struggled to exempt them from regulation; they succeeded with dire results.
- When the U.S. housing market began to slide in 2006, Dimon prioritized shedding exposure to subprime mortgages. Few other bank chiefs took the problem that seriously.
- Banker and regulators were in the dark about the real risks in regulated institutions.
- Many of them failed to react to increasing risk in mortgages and derivatives.
- Chase Manhattan purchased once-proud J.P. Morgan, the U.S. government rescued Bear Stearns and AIG, but let Lehman Brothers fail.
- Bankers and governments had to scramble to protect the overall global financial system.

Summary

Hatching the Idea

Pinpointing where and when credit derivatives were born is difficult, but a 1994 party for J.P. Morgan bankers at Florida's Boca Raton Hotel could claim that distinction. Between pranks and drinking games, the young, aggressive financiers considered new ways to profit from derivatives, which are essentially wagers on future values. Users often regard them as insurance. For example, a company may expect to receive income in foreign currency, but it pays vendors in its domestic currency. Currency markets fluctuate continuously, so how can the company make sure the foreign currency it gets will cover its obligations? The company can use a derivative to ensure that the foreign currency coming in tomorrow, next month or next year will be worth at least as much as it is today in domestic currency. The many kinds of derivatives share one trait: their value and risk depend on changes in some other asset price, like an interest rate or credit rating.

> "As with most intellectual breakthroughs, the exact origin of the concept of credit derivatives is hard to pinpoint."

By 1994, the global interest rate and currency derivatives market already had grown to $12 trillion in volume. In its early days, during the 1980s, bankers earned rich fees on relatively simple derivatives. Yet, unlike patented high-tech innovations, derivative innovations were easy to copy – and banks duplicate each other with gusto. Competition drove down the margins in the derivative business. J.P. Morgan's bankers realized that derivatives were producing an enormous proportion of their total profits. One of the best ways to keep producing such profits was to create innovative, new products other bankers could not yet match.

> "Derivatives...could do two things: help investors reduce risk or create a good deal more risk."

In Boca Raton, the financiers began to talk about a new type of derivative that would let banks insure themselves against the risk that a borrower might default. A few derivative deals for that purpose had already happened, but no one had developed credit derivatives into a real business.

Cast of Characters

The primary players in developing J.P. Morgan's derivatives and derivative credit swaps (exchanges between two parties "with complementary needs in the financial markets") were:

- **Peter Hancock** – Coming from an upper-middle-class British family, he went to Oxford. Cerebral, professorial and committed to innovation, he led the J.P. Morgan derivatives team.
- **Bill Demchak** – A middle-class boy from Pittsburgh, he earned an M.B.A. from the University of Michigan. A work-hard-play-hard type, he had strong leadership skills. His job was to implement Hancock's ideas.
- **Bill Winters** – A graduate of Colgate University, flexible, low-key, hard working, he ran the derivatives team in Europe.
- **Krishna Varikooty** – A mathematical model builder known for his ethics, he recognized the risks of mortgages and kept Morgan away from such dangerous unknowns.
- **Blythe Masters** – This British executive studied economics at Cambridge, put together Morgan's first credit derivative and became its CFO by age 34.

Forestalling Regulation

In 1991, the president of the New York Fed, E. Gerald Corrigan, acting upon regulators' dawning interest in derivatives, asked Morgan's CEO Dennis Weatherstone to talk with him about the business. Weatherstone called in Hancock to help explain it. In January 1992, Corrigan gave a speech to the New York State Bankers Association, expressing misgivings about the reasons behind the fast growth of derivative trading.

> "There was a critical juncture, around the time that Peter Hancock's team seized on the idea of credit derivatives, when financial innovation might have followed a subtly different path."

Washington's influential "Group of 30" (G30) decided to study it. Weatherstone agreed to chair the study, knowing its findings could influence future derivatives regulation. J.P. Morgan swaps banker Mark Brickell, a libertarian who opposed regulation, stepped in to defend the derivatives business against federal rule making. Known as a "Rottweiler" in the fight against regulation, he said the industry itself was best equipped to manage risk. In fact, J.P. Morgan had developed "Value at Risk," a quantitative model that is used to assess a portfolio's probability of loss. Brickell's tenacious antiregulation lobbying ruffled feathers in Washington, but the regulators backed off from derivatives. The G30 report prescribed in detail how banks should manage derivative risk, but accepted the proposition that government intervention was unnecessary.

BISTRO Action

Soon after the 1994 Boca Raton party, Blythe Masters arranged a credit swap with the European Bank for Reconstruction and Development that let J.P. Morgan offload the credit risk of a loan to Exxon without actually selling the loan itself. She and Demchak began calling on regulators to see if banks using credit derivatives to offload credit risk could carry lower capital reserves. In 1996, the Fed approved. J.P. Morgan applied securitization technology, bundling pools of loans and selling the bundles to special-purpose vehicles (SPVs) that were paid to insure against the risk of default. The SPVs sold these loan-backed securities to other investors, putting the proceeds in very creditworthy securities to guarantee funds for payment in the event of default.

> "In the absence of regulatory oversight, the eventual innovation frenzy would later fuel a boom beyond all bounds of rational constraint – or self-discipline."

J.P. Morgan called this innovation the "broad index secured trust offering," BISTRO for short. Members of Morgan's derivatives team pocketed rich bonuses as business boomed. However, regulators raised some troubling questions, particularly, what if defaults were so widespread that the SPVs cushion (the funds it invested in high-rated securities) was insufficient? The bankers saw this as highly unlikely, because the risk that concerned regulators was safer than AAA ratings require. American International Group (AIG) began to build a business insuring banks against this "super-senior risk" even as bankers eventually persuaded regulators that the super-senior risk was not risky enough to require capital reserves.

> "That created the potential for a chain reaction; if SIVs collapsed...money-market funds would suffer losses and consumers would then suddenly discover that their supersafe investments were not so safe."

In 1999, a German bank, Bayerische Landesbank, asked J.P. Morgan for help. It wanted to use the BISTRO approach to offload its $14 million U.S. mortgage loan risk. After analysis, Varikooty said he could not derive a precise estimate of the default risk, because determining the correlation of mortgages across the entire U.S. was impossible. Not wanting to say no to Bayerische Landesbank, Morgan did the transaction, paying so much to hedge the risks that the deal was not very profitable. J.P. Morgan's bankers soon began to hear of other banks selling credit default swaps against mortgages. They wondered how those banks were handling the risk.

Perverting Innovation

J.P. Morgan had a proud tradition and a tightly knit, rather conservative culture. During the 1990s, banks began to move into nontraditional businesses, a trend accelerated by the 1999 repeal of the Glass-Steagall Act, which previously limited their role. Financial institutions gobbled each other up in a merger mania that created huge financial supermarkets. J.P. Morgan began to look small and stodgy compared to its peers. The apparent setting of J.P. Morgan's star contributed to the 2000 resignation of derivatives chief Peter Hancock. Shortly after he left, Chase Manhattan bought J.P. Morgan – a humiliating shock to Morgan's tradition-proud bankers. Bill Demchak, now co-head of credit in the newly merged institution, realized that Chase was earning revenue dangerously, by making highly risky loans to the Internet sector and to scandalous borrowers. In 2001, when the Enron scandal broke, Chase was in the headlines. It also was a lead banker for Global Crossing and WorldCom, both scandal-plagued. Chase apparently did not share a tradition that began at J.P. Morgan a half-century ago, when founder J. Pierpont Morgan's son J.P. "Jack" Morgan Jr., mandated conducting a "first-class business...in a first-class way."

Jamie Dimon Comes to J.P. Morgan

In 2000, Demchak resigned from Chase, followed by the ethical, meticulous Varikooty. Meanwhile, other financial institutions raced to imitate BISTRO. They pushed the risk envelope, not only doing deals against the ordinary mortgages that J.P. Morgan had found too risky when approached by Bayerische, but even doing deals against subprime mortgages. Rating agencies approved such deals, in part, because if one rating agency refused to bless a deal, the bank could take the deal and its revenues to another agency. Losses on credit drove Chase's stock price down (as Demchak had feared), paving the way for its merger with Bank One, whose CEO

Jamie Dimon became CEO of Chase in January 2004. Dimon had been pivotal in building Citigroup and had turned Chicago's faltering Bank One into a powerhouse. A detail-oriented manager, Dimon worried about costs and risks.

The Business of Risk

Dimon wanted Chase to catch up with the rest of the industry on mortgage securitization, so he set up a team for that purpose. Shortly, though, he began to worry about the risk. Some anomalies were cropping up in the housing market. Borrowers were starting to default on high-risk mortgages, even though the economy was strong and mortgage interest rates were low. Other banks continued to take mortgage risk, but J.P. Morgan started looking for ways to cut its exposure. Even experts like Winters, part of the original Morgan credit swap team, could not understand how other banks could manage mortgage-related risk and still make profits. Then, the housing market stalled and began to slide. Chase's annual revenue lagged its competitors by some $1.5 billion because of the money its rivals were making on mortgage securitization. Fortunately, Dimon accepted his team's risk analysis. As real estate fell and housing dropped, he insisted on getting out of mortgages, especially subprimes. Demchak, now vice-chairman of PNC Bank in Pittsburgh, did the same. Yet, other banks continued assuming mortgage risks as if nothing had changed. So, for that matter, did financial regulators – for the most part.

> "Faced with a financial system that few people seemed to understand anymore, the G8 did nothing – other than hope that the losses...in the U.S. subprime mortgage world would be absorbed quickly."

Bank for International Settlements economists warned the industry about potential risks from financial innovations in 2003, at a conference in Jackson Hole, Wyoming. Alan Greenspan's Fed took a strong pro-market, pro-innovation approach, but other central bankers were skeptical, including [now U.S. Treasury Secretary] Timothy Geithner, president of the New York Fed. In 2007, Germany's G8 representatives worried that hedge funds were a source of massive, hidden risk. Jim Chanos, a prominent hedge fund founder, attended a meeting where financial officials mulled those concerns. "It's not us you should be worrying about – it's the banks!" he said, but his warning seemed to fall on deaf ears.

Fear and Panic

In June 2007, problems at a Bear Stearns hedge fund hit the headlines. J.P. Morgan had made loans to the fund, and demanded its money back. Merrill Lynch, which also extended credit to the fund, threatened to sell the collateral – complex securities that would have driven down the market – and made Bear Stearns's problems worse. Bear avoided that by giving the fund emergency credit. Another crisis hit in July in Germany. Deutsche Industriebank had a special enterprise that raised funds by selling commercial paper, which it had invested in mortgage-backed securities. As rating agencies moved to downgrade mortgage-backed securities – especially those with subprime mortgages – the German bank unit couldn't find buyers for its commercial paper. J.P. Morgan could not help but the German government itself intervened with a plan to support the bank.

> "'Pile 'em high and sell 'em cheap!' Tim Frost, a young trader, sometimes quipped. He was utterly convinced that a mass-market approach could be found for derivatives."

Throughout 2007, fears spread about the global financial system. A liquidity crisis made bankers and investors unwilling to take risks they no longer felt they could understand. Central bankers took unprecedented actions in Europe, where the European Central Bank publicly announced that it would support the markets. The Bank of England, however, was inclined to let market discipline take its course against imprudent bankers and investors. By August, the U.S. situation was serious enough for President George W. Bush to offer public, rhetorical reassurance. Bankers, regulators and the public discovered the existence of a vast shadow banking system, a source of immense hidden risk.

> "'The fact is that every five years or so, something bad happens. Nobody ever has a right to not expect the credit cycle to turn!' Dimon kept saying."

Regulators and bankers scrambled to protect the system from collapse. In 2008, the Treasury and the Fed blew hot and cold on rescuing institutions, saving Bear Stearns, letting Lehman fail, then saving AIG. Dimon summed up the course of events, "We think we are going to be fine, in terms of our bank," he said. "But it's going to be very, very ugly for others. Worse than anything that any of us have seen in our lives."

About the Author

Gillian Tett, Ph.D., runs global coverage for the *Financial Times.* She was named British Business Journalist of the Year in 2008 for her coverage of the financial crisis.