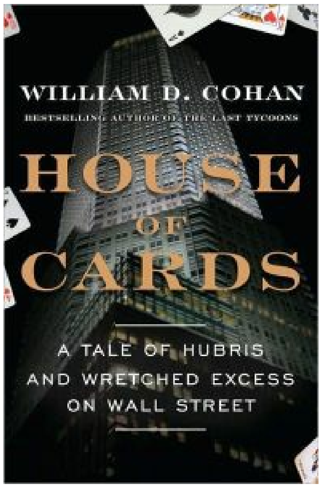

Book House of Cards

A Tale of Hubris and Wretched Excess on Wall Street

William D. Cohan
Doubleday Broadway, 2009
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Recommendation

The 2008 collapse of leading Wall Street investment house Bear Stearns showed the world just how rickety the global financial system had become. William D. Cohan tracks the firm's dizzying rise and rapid collapse. His access to Bear Stearns insiders is the book's strongest point. He offers a trenchant analysis of its decades-long rise and a definitive account of its final days. Cohan paints textured portraits of Bear's top people, though he isn't especially interested in translating their Wall Street jargon for lay readers. He lets his sources speak in their own patois. *BooksInShort* recommends this book to business history buffs, investors and managers seeking perspective on a spectacular failure.

Take-Aways

- Bear Stearns collapsed soon after the ouster of longtime CEO, Jimmy Cayne.
- During Cayne's watch, his pay as CEO soared, as did the firm's profits and assets.
- Three CEOs, Cayne, Ace Greenberg and Cy Lewis, shaped Bear's culture.
- Bear boasted a $400 billion balance sheet, occupied a new $1.5-billion headquarters and gave its executives Wall Street's most generous compensation package.
- Cayne failed to diversify Bear Stearns's business and only vaguely understood the risk of complex mortgage-backed securities.
- The fatal run on Bear's assets began when investors and lenders questioned its liquidity. In March 2008, Bear Stearns went from solvent to illiquid within 24 hours.
- On Thursday, March 16, JPMorgan Chase CEO Jamie Dimon began negotiating to buy Bear Stearns.
- After an all-nighter, JPMorgan and the Fed announced funding for "up to 28 days."
- Investors were suspicious of the deal. On Friday, Bear's shares plunged 50% to $30.
- The Fed insisted Bear be taken over by Monday – and it was. JPMorgan paid $2 a share, closing Wall Street's titan.

Summary

Bear Stearns's Fast Fall

March 2008: The historic housing boom had reversed. The bubble hadn't burst entirely, but signs of trouble loomed. Thornburg Mortgage was beset by margin calls, while Carlyle Group, a private equity firm, hit a rough spot when its residential mortgage-backed securities proved difficult to value as housing prices fell. Those firms were relatively obscure, but Bear Stearns was not. Bear was Wall Street's fifth-largest securities firm, with a $400 billion balance sheet and a new $1.5 billion headquarters. Its executives were the best-paid people on Wall Street. A hugely profitable titan, feared by its rivals, it was a household name abruptly facing shocking collapse.

> "Nothing seemed amiss at Bear. But some inside the firm were very scared."

Longtime chairman Ace Greenberg had become a cult figure for, among other things, his quirky insistence that staffers recycle paper clips from incoming mail. Bear's annual Palm Beach media conference drew the heads of Viacom, Disney and NBC Universal. Its failure was nearly unthinkable. But, given Bear Stearns's heavy exposure to the suddenly collapsing mortgage market, other traders began to whisper about its liquidity crisis. Despite the rumors, or maybe due to them, Bear presented itself as a strong player. On March 4, it said that on March 20 it would release first-quarter results showing a $115 million profit and $17.3 billion "available liquidity."

> "Since Wall Street is a confidence game...for counterparties on routine trades to start asking pointed questions about things as fundamental as cash and liquidity is not...good for business."

Not everyone was convinced. One anonymous Yahoo! message board writer described Bear Stearns as "way overleveraged." On March 5, hedge fund manager Bennet Sedacca wrote on the Minyanville Web site that Bear Stearns and Lehman Brothers were about to take massive hits. Both held large amounts of mortgage-backed securities, but the value of the homes underlying those securities was plummeting. Sedacca scoffed at the "nuclear waste" in both banks' portfolios. On March 6, Tim Geithner, president of the Federal Reserve Bank of New York [now U.S. Treasury Secretary], warned that the economy was on shaky footing due to an era of loose credit and Wall Street's "rapid innovation" of products like credit default swaps.

> "The Bear Stearns board's lack of involvement...in the firm's financial meltdown could be interpreted as a near-abdication of its fiduciary responsibility."

Jim Cramer, host of the CNBC TV show *Mad Money*, remained a Bear Stearns cheerleader. On March 6, with Bear Stearns shares at $69, Cramer told viewers, "I'm not giving up." But some of Bear's crucial trading partners were. When Bear asked a major European bank for $2 billion in short-term credit, it said no. "Being denied such a loan is the Wall Street equivalent of having your buddy refuse to front you $5 the day before payday," wrote *Fortune* magazine's Roddy Boyd. The hits kept coming. Monday, March 10, Bear Stearns shares fell 10% after Moody's downgraded 15 mortgage bonds. The Rabobank Group of the Netherlands refused to renew a $2 billion line of credit. But, Bear Stearns CEO Alan D. Schwartz kept denying that anything was amiss, saying publicly, "Bear Stearns's balance sheet, liquidity and capital remain strong."

> "Dimon quickly realized that the bankruptcy of...Bear Stearns would be a disaster."

The skeptics massed. On March 10, the most popular option on Bear Stearns shares was a bet that the stock would trade at $30 on March 21, a stunning 50% decline. Some traders on that path could have been institutions looking to hedge the risk of a Bear failure. One unknown trader bet $1.7 million that Bear Stearns's shares would drop more than 50%, a wager so improbable that one observer likened it to "buying a lottery ticket." Aggressive options trades fed rumors among financial regulators, traders, journalists and clients that a run on the bank was imminent. On Tuesday, March 11, Dutch bank ING Group rescinded Bear's $500 million financing commitment. Banking research analyst Richard X. Bove predicted that Bear would have to be sold because it "did not get out of the way fast enough."

The Bank Run Intensifies

Cramer again took Bear's side. On *Mad Money* on March 11, he said, "Bear Stearns is not in trouble! If anything it is more likely to be taken over. Don't move your money from Bear. That's just being silly!" On March 12, Schwartz appeared on CNBC and sounded similar themes, though in less colorful language. He said Bear had a $17 billion cash cushion. "We don't see any pressure on our liquidity, let alone a liquidity crisis," Schwartz told viewers. Many insiders weren't so optimistic. Later that day, Schwartz met with Bear Stearns executives who urged him to sell some of its $15 billion in liquid securities to raise cash. Schwartz declined, fearing that would "signal" weakness to the market.

> "It became clear that the terms on which JPMorgan would lend Bear Stearns money would be onerous indeed."

When Schwartz spoke with Geithner on Wednesday, March 13, many insiders thought he was overly optimistic. Saudi investors offered to inject "a significant amount" to keep Bear afloat, but Schwartz responded, "We don't need capital." Other executives told him clients were pulling money out – hedge fund giants D.E. Shaw and Renaissance Technologies removed billions – and that the firm was teetering. Schwartz tried to reassure his managers that everything would be fine, a disconnect one major client called "surreal."

> "The Fed and the Treasury were closely examining Bears' liquidity at the end of Friday and were not happy."

Meanwhile, pressure on mortgage-backed securities intensified. Bear Stearns was in a deepening hole. Clients were pulling money out rapidly and other firms stopped honoring its trades. On Friday, March 7, Bear Stearns had $18.3 billion in cash, but from the morning of March 12, the following Wednesday, to the next afternoon, it went from "solvent to dead," as one executive recalled. By Thursday, March 13, Bear had only $5.9 billion in cash. It owed Citigroup $2.4 billion, and had borrowed billions on the repo market. The once-vaunted firm was on the edge of a collapse that could roil markets across the globe.

> "The price must be a typo...since surely a company that 14 months earlier had been trading at $172.69 per share could not now be worth so little."

On Thursday night, Jamie Dimon, chairman and CEO of JPMorgan Chase, was celebrating his 52nd birthday at a Manhattan restaurant when he got a call from Schwartz asking for $30 billion. Dimon said no, but quickly phoned Geithner, Federal Reserve Chairman Ben Bernanke and then-Treasury Secretary Hank Paulson. Dimon concluded that Bear's collapse would be disastrous, so he changed his mind about helping it in some way. JPMorgan Chase and Bear Stearns executives convened a series of all-night meetings. By Friday morning, Bear Stearns executives were celebrating. They thought Bear had bought some critical time. But when JPMorgan Chase announced the details behind its effort – in tandem with the Federal Reserve – to provide crucial funding to Bear Stearns, its executives stopped celebrating. The announcement did not mention JPMorgan buying Bear, and it promised funding for only, "an initial period of up to 28 days." JPMorgan's announcement stressed that the arrangement posed no risk to its shareholders.

> "The roots of the firm's problems are found deep in its unique corporate culture."

Investors welcomed the news at first. Bear shares rose 10% to $64. By 10:15 a.m., though, shares plunged to $30. Oppenheimer analyst Meredith Whitney downgraded Bear Stearns as too highly leveraged, saying that its reputation had taken a deadly blow. "A company is only as solvent as the perception of its solvency," she wrote. Standard & Poor's, Moody's and Fitch slashed their ratings on Bear's debt. Bear's CEO Schwartz kept his upper lip stiff. When Steve Schwarzman, billionaire co-founder of the Blackstone Group, called that day to offer help, he said no.

A Weekend of All-Nighters

Bear Stearns stressed-out managers went home for the weekend with the impression that they had bought 27 days to turn the firm around. By then, though, Geithner and Paulson had begun to scrutinize Bear Stearns, and they didn't like what they saw. The pair called Schwartz and told him Bear couldn't open for business on Monday. "The run accelerated over the course of the day Friday, and I wasn't going to lend into the run," Geithner said. Bear Stearns's executives faced the sickening reality that their 28-day deal with the Fed and JPMorgan was really a one-day deal.

> "The holy grail of investment banking became increasing short-term profits and short-term bonuses at the expense of the long-term."

That led to another series of all-nighters over the weekend as some 200 of JPMorgan's top executives began digging into Bear Stearns's books. Dimon warned that JPMorgan was likely to pay only $10 a share. That struck the Bear managers as insultingly low, but it hit some of Dimon's own people as ridiculously high. One JPMorgan senior banker asked why his firm would take on the ruined company, "other than out of some patriotic sense of obligation?" Indeed, JPMorgan concluded that Bear Stearns had overvalued its mortgage securities and walked away from the deal entirely. Worried about the fallout if Bear liquidated, the Fed agreed to take $30 billion of Bear Stearns's most toxic assets. That assurance brought JPMorgan back to the table, but its offer plunged to $4 a share, then $2.

> "[Cayne] could decide when to buy or sell a stock, but when it came to understanding the calculus of and risks inherent in, say, a CDO-squared (that is, a collateralized debt obligation backed not by a pool of bonds and loans but by CDO tranches), well, that was a bridge too far."

Bear insiders were outraged. A mere 14 months earlier, when Bear led the financial world, its shares topped $172. No one suffered from its collapse more acutely than longtime CEO Jimmy Cayne, who was chairman at the time. At Bear's peak, his six million shares were worth more than $1 billion. Now, they were worth $12 million. Bruce Sherman, head of Private Capital Management in Naples, Florida, was another big loser, taking a $475 million hit. Sherman came to Cayne's office on Monday morning. "There was a mugging," Cayne told him. Others used stronger language. When Dimon spoke to Bear Stearns's troops and described the merger as a "shotgun wedding," a Bear broker stood up and retorted, "I'd call this a shotgun wedding to a rapist." Cayne toyed with rejecting the JPMorgan offer and filing for bankruptcy instead, but by the time the shareholders met, JPMorgan had amassed nearly half of Bear's shares to ensure that the vote would go its way. In May, Bear Stearns shareholders overwhelmingly approved the deal.

Bear's Peculiar Culture

Bear Stearns didn't collapse in one month, of course. Its decades-long history and peculiar culture set it up for dizzying success and a vertiginous fall. Three forceful leaders largely shaped the firm: Cy Lewis, Ace Greenberg and Jimmy Cayne. Lewis, a gruff giant, sold shoes before joining Bear Stearns in 1933. He made his mark loading up on depressed railroad bonds. The government had seized the trains for the war effort, so bonds traded for as little as five cents on the dollar. Lewis bet the firm on this gambit, which paid off handsomely after the war, when the bonds soared. He also pioneered block trading: buying and selling large chunks of stock for institutions.

> "The blame for the firm's failure to diversify, as Cayne now admits, rested squarely on his shoulders."

In 1949, Bear Stearns hired a new clerk, Alan C. "Ace" Greenberg, a Midwesterner who came to Wall Street after college. Within a few years, he ascended to head of risk arbitrage. Greenberg's star rose in the early 1960s when he persuaded Lewis to sell money-losing positions so that the firm could buy up American Viscose. A takeover caused shares to spike. Lewis, meantime, was losing internal power as his heavy drinking hurt his credibility.

> "Cayne was the only billionaire CEO among the titans of Wall Street securities firms...that put an extra swagger in his step [because] a college dropout and self-made man had bested the lot of them doing it his way."

In 1969, Greenberg hired Cayne to help launch Bear Stearns's retail brokerage unit. Cayne was an unpolished hustler, a champion bridge player who had dropped out of college, and hungered for respect and money. He excelled at Bear, rising to become the firm's number two partner in the early 1980s. He befriended his boss, as much as anyone could befriend the notoriously chilly Greenberg. He required all partners to give 4% of their pay to charity. In his tone-deaf way, he made a $1 million donation in 1998 to buy Viagra for men who couldn't afford it, but said he gave the money because he owned Pfizer shares. He was notoriously cheap. Writing under a pseudonym, he sent out memos urging staffers to use inter-office envelopes twice by licking only half of the glue strip each time.

As Wall Street firms began to go public, starting with Donaldson Lufkin Jenrette in 1970 and Merrill Lynch in 1971, the risk calculus shifted. Once, a firm's partners took the risks. Now, they pushed the risks onto faceless shareholders. Slowly, Wall Street began to chase short-term scores and year-end bonuses at the expense of long-term profitability. Greenberg and Cayne were Wall Street's highest-paid executives in 1987, a trend that held until Bear's collapse. Cayne succeeded Greenberg as CEO, and lived very well for years, savoring $150 cigars and compensation packages as high as $25 million a year. At the market's 2006 peak, he was the only billionaire CEO among Wall Street securities firms, based on his huge holdings of Bear Stearns shares.

Cayne did not earn all that money due to his encyclopedic command of the latest arcane Wall Street products. In fact, he didn't realize just how risky Bear's mortgage-backed portfolio had become. For example, Bear's Ralph Cioffi ran a hedge fund full of mortgage-backed securities, but he told investors it held less risky assets backed by credit cards and auto loans. Cayne and his cohorts had little idea what Cioffi was up to, even as the fund imploded. Unlike Greenberg, who told employees to bring such problems to his attention anonymously, Cayne seemed uninterested in details or in diversifying the business. He scoffed at a 2001 opportunity to purchase asset manager Neuberger Berman, and dismissed a 2002 offer by Dimon, then at Bank One, to buy Bear Stearns. In fact, Cayne's behavior grew erratic by 2007. While other firms raised capital, Cayne did nothing. He disappeared in mid-crisis to play bridge and golf. In January 2008, Schwartz replaced Cayne as CEO, but the die was already cast. Bear Stearns would soon be gone.

About the Author

William D. Cohan, former senior Wall Street investment banker, is the author of the *New York Times* bestsellers *House of Cards* and *The Last Tycoons*. That book also received the Financial Times Goldman Sachs Award. He writes for the *Financial Times*, *The Atlantic*, *The New York Times* and *The Washington Post* and is a contributing editor to *Fortune* magazine.