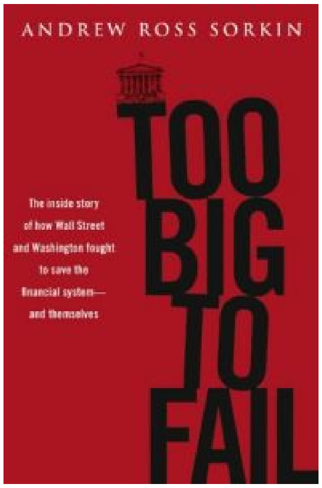

Book Too Big to Fail

The Inside Story of How Wall Street and Washington Fought to Save the Financial System from Crisis – and Lost

Andrew Ross Sorkin
Viking, 2009
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Recommendation

The ever-growing pile of books about the Great Recession holds two kinds of tomes: those that pontificate about what went wrong and what should change, and those that detail the minute-by-minute action in the boardrooms of Wall Street and Washington. This book is the second kind. *New York Times* reporter Andrew Ross Sorkin, who gained access to many high-level financial players, provides an ambitious, remarkably detailed account of the collapse and bailouts of 2008. He accomplishes two noteworthy feats: He digs up information that wasn't widely known, and he beautifully writes a page-turning yarn. *BooksInShort* recommends his book to investors, policy makers and businesspeople who seek a clear observer's perspective on Wall Street's meltdown.

Take-Aways

- In 2008, Lehman Brothers investment bank wavered on the brink of collapse.
- Lehman CEO Richard S. Fuld Jr. blamed the bank's falling stock price on short-sellers.
- Refusing to acknowledge his firm's weakness, Fuld sought a cash infusion from Warren Buffett, and pursued mergers with Barclays and Bank of America.
- Treasury Secretary Henry "Hank" Paulson refused to use taxpayer money to rescue Lehman.
- Lehman filed for bankruptcy in September 2008.
- The next day, Paulson revealed American International Group's $85 billion bailout.
- Investors were confused by the mixed message. Lehman could fail, but AIG couldn't.
- To calm the markets, Paulson pushed through a plan that would give the government $500 billion to buy toxic assets.
- Congress balked, so Paulson reworked the plan to take direct ownership of shares in banks, and got top bankers to concur.
- The Troubled Asset Relief Program stabilized banks, shored up investor confidence and put the market on the road to recovery.

Summary

Lehman Teeters and Puts All of Wall Street on the Brink

In September 2008, Wall Street and the U.S. economy faced a calamitous collapse. Only a year before, the markets had celebrated eye-popping profits fueled by mortgage innovations. Those in the finance industry rewarded themselves well, garnering "an astounding $53 billion in compensation in 2007." Goldman Sachs CEO Lloyd C. Blankfein made $68 million. Then the inflated real estate market collapsed, and Wall Street began to teeter. Its debt-to-capital ratio was 32 to 1, a level of risk that guaranteed profits in boom times but proved ruinous in a bad market.

> "In a period of less than 18 months, Wall Street had gone from celebrating its most profitable age to finding itself on the brink of an epochal devastation."

On March 17, 2008, JPMorgan Chase said it would rescue Bear Stearns in a fire-sale deal. Meanwhile, Lehman Brothers, another investment bank, was on the brink of failure. Its derivatives trading partners were skittish and its investors were leery, sending its once-solid stock swinging wildly; shares plunged as much as 48% in an hour of trading. Although Lehman CEO Richard S. Fuld Jr. was responsible for the firm's risky approach, in some ways it didn't fit his usual style. Even as he had ramped up risk, Fuld had occasionally reminded his people that his approach had pitfalls. Then tough times came harder and faster than he'd expected. Nicknamed "The Gorilla" for his aggressive, intimidating style, Fuld had seen his share of tumult, including the Asian contagion of the 1990s and the September 11, 2001, terrorist attacks. Spurred by the success of Goldman Sachs, Fuld had pushed Lehman's leverage far beyond its conservative roots.

> "The shape of Wall Street and the global financial system changed almost beyond recognition."

The strategy had paid off handsomely during the mortgage bubble, when Fuld's Lehman shares lifted his net worth to $1 billion. But, after Bear's panic sale, when investors and TV talking heads looked for the next victim of the mortgage meltdown, all signs pointed to Lehman. Even those who saw Lehman's potential failure as just an example of capitalism at work knew it could be disastrous to the financial markets that held the savings of millions of people and paid tens of thousands of workers who, unlike Fuld, didn't collect $40 million annual compensation deals.

> "Fixed-income trading was nothing like Fuld and Gregory knew in their day: Banks were creating increasingly complex products many levels removed from the underlying asset."

If Lehman failed, Citigroup, Merrill Lynch and others were in danger. The task of saving financial markets fell primarily to President George W. Bush's Treasury secretary, Henry "Hank" Paulson, the former leader of Goldman Sachs; Timothy Geithner, head of the NY Federal Reserve (later the Obama administration's Treasury secretary); Jamie Dimon, CEO of JPMorgan Chase; and Ben Bernanke, Federal Reserve chair. When Paulson and Dimon had worked on Bear's rescue, Paulson had urged Dimon to offer $2 a share. Dimon went to $10 so shareholders would not reject it. Paulson thought that was better than Bear deserved.

> "'We have to prepare for the absolutely worst case,' Dimon told his [JPMorgan Chase] staff...'This is about our survival'."

As Lehman's shares and liquidity fell, Fuld approached Warren Buffett for a cash infusion. Buffett said no; he thought the business was too risky. Fuld had ramped up its leverage ratio to 30.7 to 1. Obsessed with his conviction that short-sellers caused the collapse in Lehman's shares, Fuld constantly griped that the "shorts" were spreading false rumors. He asked CNBC host Jim Cramer to tell his viewers that Lehman was fine. "You really need cash," Cramer said to Fuld, who insisted, "Our balance sheet has never been this good." Short-seller David Einhorn was among the investors who foresaw big problems at Lehman. He was especially troubled by the way it valued illiquid assets such as mortgages. On May 21, 2008, Einhorn urged investors at a high-profile conference to sell Lehman stock short. He argued that the firm had been slow to mark its illiquid assets down to their true value.

> "Cassandras in both business and academia...warned that all this financial engineering would end badly."

While Fuld blamed short-sellers for Lehman's troubles, many insiders pointed to his right-hand "hatchet man," Joseph Gregory, who usually handled unpleasant personnel matters like firings. His spending habits made him a caricature of a Wall Street fat cat. He commuted from his Bridgehampton mansion to Lehman's Manhattan offices by helicopter. While Fuld and Gregory ran Lehman, Wall Street's bread-and-butter business changed dramatically. Banks no longer made and held loans. Instead, they focused on originating loans that changed hands many times as their assets were packaged into derivatives. The final product bore little resemblance to the original loan. Lehman traders laughed at Gregory's lack of market savvy, but they knew he punished disloyalty severely and feared speaking against the firm's increasingly risky approach. Gregory wanted to do more such transactions and did not want to hear dissenters' concerns.

Bankruptcies and Bailouts

As Lehman teetered, giant insurer American International Group (AIG) also neared the brink. AIG's executives had convinced themselves things were fine because it had $40 billion in cash, $1 trillion in assets and a lucrative business underwriting insurance on collateralized debt obligations. "It was simply too big to fail." But with the mortgage market falling, matters didn't stay fine for long. AIG had insured more than $500 billion in subprime mortgages, primarily for European lenders. As its managers revalued credit default swaps, they learned that its November and December 2008 losses approached $5 billion, well above the $1 billion previously estimated. By May, it reported a first-quarter loss of $7.8 billion, its biggest ever. Standard & Poor's cut AIG's rating to AA minus.

> "Hank Paulson believed he was fighting the good fight...to save the economic system, but for his efforts he was being branded as little less than an enemy...to the American way of life."

Paulson knew a bailout was necessary. As he announced government takeovers of ailing mortgage giants Fannie Mae and Freddie Mac, critics labeled him a "socialist" and "Mr. Bailout." The accusations shocked Paulson, who had made hundreds of millions as head of Goldman Sachs and who staunchly supported the conservative Bush. These jibes colored his approach in the following months. For instance, when Barclays, a British bank, asked for government help in assembling a deal to buy Lehman, Paulson said no. Lehman's worsening decline became clear when JPMorgan Chase asked it to return $5 billion in collateral. Lehman appealed to Geithner for help, but he said he couldn't tell JPMorgan or any other bank, "not to protect itself." As Barclays negotiated to buy Lehman, Fuld's behavior remained baffling. At one meeting, he instructed Barclays' President Bob Diamond to "look into the whites of my eyes," and offered to step aside after the merger. This confounded Diamond, who had long assumed that Fuld wouldn't stay. For all of Fuld's bluster, he, like most Lehman execs, had a huge chunk of his net worth tied up in the firm. In months, he lost $649 million as the value of his 10.9 million shares plunged.

> "Buoyed by their earnings, AIG executives stubbornly clung to the belief that their firm was invulnerable."

Paulson and Geithner convened a meeting of Wall Street CEOs to discuss a private bailout of Lehman because, as they explained, a federal bailout wasn't going to happen. Lehman's rivals did not react positively, since rescuing a competitor meant hurting themselves. Paulson excluded Fuld from the meeting, describing him as being "in denial" and "dysfunctional." Bank of America CEO Ken Lewis agreed to consider buying Lehman, but after digging into its books, he quickly gave Fuld the cold shoulder. Tired of being ignored, Fuld called Lewis at home. Lewis' wife told him, "You really have to stop calling. Ken isn't coming to the phone." Paulson and

Geithner desperately tried to keep Lewis engaged because Barclays was still pursuing Lehman, and the government much preferred bidding by two different parties.

> "AIG was such a sprawling mess, and its computer systems so bizarrely antiquated, that no one had until that moment discovered that its securities lending business had been losing money at a rapid clip for the past two weeks."

The worth of Lehman's assets remained a gaping question. The firm officially valued its loans and investments at $42 billion, though many pegged the true figure at less than half that amount. Barclays remained interested, but when it neared the cusp of a deal, British regulators informed Diamond, Paulson and Geithner that they wouldn't approve it. They said Lehman represented a "cancer" that threatened to infect the U.K.'s financial system. With no viable buyers for Lehman, Paulson and Geithner decided it should file for bankruptcy. When that happened, its shareholders faced huge losses. Fuld's millions of dollars in shares now had a value of only $65,486.72.

> "Eighty-five billion dollars was more than the annual budget of Singapore and Taiwan combined; who could...understand a figure of that size."

Like Fuld, AIG's CEO Robert B. Willumstad approached Warren Buffett for a bailout. He offered to sell AIG's property and casualty arm to Buffett for $20 to $25 billion. When Willumstad said he'd e-mail a package of data to Buffett, the billionaire laughed and said he didn't use e-mail; Willumstad faxed it instead. Buffett needed only an hour to reject the proposal.

> "For better or worse, Goldman, like so many of the nation's largest financial institutions, remains too big to fail."

The markets were so unstable that Dimon told his JPMorgan management team to anticipate not just the failure of Lehman and AIG, but also the collapse of Merrill, Morgan Stanley and Goldman Sachs. Merrill was on the edge of a cliff. A year earlier, its then-CEO, Stanley O'Neal, had discussed a deal with Bank of America (BOA). But O'Neal had wanted a richer premium than BOA head Lewis would pay. Paulson urged Merrill's new CEO, John Thain, to make a deal with BOA. If Merrill wasn't sold quickly, Paulson told Thain, "Heaven help you and heaven help our country." BOA paid $29 a share for Merrill, the richest premium in bank merger history.

An $85 Billion Bailout for AIG

As JPMorgan's investigators delved into AIG's books, nasty surprises kept mounting. Willumstad and AIG's other leaders scarcely knew how much its securities lending operation was losing. AIG estimated its losses at $40 billion, but JPMorgan found that $60 billion was more realistic. AIG had engaged in risky lending, but it also productively sold annuities, bonds and life insurance. Telling Bush that the collapse of AIG's far-flung empire would hurt middle-class families, Paulson and Bernanke engineered an $85 billion bailout. When Congressman Barney Frank incredulously asked Bernanke if the Fed had $80 billion, he said it had $800 billion.

> "They got to the question Geithner and Paulson had been debating all day: How forceful could they be?"

The $85 billion infusion into AIG didn't calm the markets. Its rescue came only 24 hours after Lehman's failure, so the government's apparently schizophrenic approach confused investors and roiled markets. What were the rules? How could the feds let one firm fail and save another? This question left Paulson and Geithner little choice but to stage an even more dramatic bailout. Paulson pitched Bush and Congress on a $500 billion plan to shore up the markets by buying toxic assets. On September 19, 2008, he announced the Troubled Asset Relief Program (TARP). Privately, Paulson's advisers told him the price tag might approach $1 trillion, but he knew that stating such a huge number was political suicide. Meanwhile, Paulson had become a major player in Washington. The cover of *Newsweek* magazine dubbed him "King Henry."

> "It was the first time – perhaps the only time – that the nine most powerful CEOs in American finance and their regulators would be in the same room at the same time."

Goldman Sachs fared far better than Lehman or AIG. It gave Buffett very favorable terms for buying a $5 billion stake in the firm. Buffett's thumbs-up led other investors to snap up an additional $5 billion in Goldman shares. But while Goldman was in the clear, King Henry's TARP program wasn't. Congress voted it down amid Republican concerns that it represented creeping socialism, and Democratic fears that Paulson was helping his Wall Street buddies. The stress was getting to Paulson, who, on occasion, interrupted his work to dry heave into the trash can. Investors weren't feeling much better. The day Congress voted down TARP, the Dow Jones lost 777.68 points, history's largest single-day fall. Chastened, Paulson rethought his proposal. He heeded the suggestion of Assistant Treasury Secretary Neel Kashkari that instead of buying toxic assets, the feds should invest in bank ownership. Sheila C. Bair, head of the Federal Deposit Insurance Corporation, agreed to raise its bank coverage limits. The last thing the feds wanted was to buy a stake in the nation's largest banks just in time to see depositors flee.

> "The bankers sat stunned. If Paulson's aim had been to shock and awe them, the tactic had worked spectacularly well."

Paulson summoned the heads of Wells Fargo, JPMorgan Chase, Goldman Sachs and six other large banks to a secret meeting with regulators. He refused to tell the CEOs why he was convening them. His message: To shore up banks, the government was going to use TARP to buy $250 billion in preferred shares in the big banks. If the CEOs refused to accept the influx of Uncle Sam's capital, they'd face regulatory scrutiny. To convey the gravity of the plan, Paulson had Geithner and Bernanke on hand along with other banking regulators, including Bair. Realizing the seriousness of the financial situation and cowed by Paulson's intimidating approach, most of the nine bankers quickly went along with the plan.

However, there were questions. Wells Fargo Chair Richard Kovacevich, a tough sell, wondered why the feds would punish his bank for the risky practices of New York banks with their "fancy products." Paulson told him that if he didn't take TARP money, regulators would label his bank undercapitalized and force it to raise capital privately. Merrill's John Thain wanted assurances that no one would touch his compensation. Paulson told the CEOs to phone their board members to discuss the plan. Jamie Dimon told his board the plan was "asymmetrically bad" for JPMorgan Chase. After all, his bank was financially healthy and the plan would save several of its rivals. But Dimon also told his board members that taking TARP money would work for the good of the financial system. In the end, all nine CEOs signed on to the plan and Wall Street eventually bounced back from the crisis.

About the Author

Andrew Ross Sorkin is the chief mergers-and-acquisitions reporter and columnist for *The New York Times*. He founded DealBook, an online daily financial report.