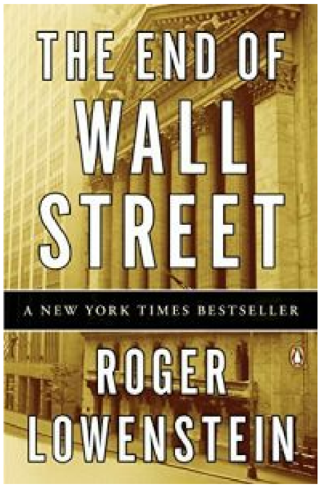

Book The End of Wall Street

Roger Lowenstein
Penguin Group (USA), 2011

Recommendation

How did mortgage loans to not-quite-prime borrowers evolve into the engine of doom for Wall Street? Journalist and best-selling author Roger Lowenstein uncovers the root causes and the culmination of the 2008 financial debacle. He explains how loans to formerly unattractive clients brought out the best in Wall Street innovation and the worst in Wall Street greed. His behind-the-scenes look at the people involved, their backgrounds and their decision making is a fascinating depiction of how the mortgage ball got rolling. Lowenstein's recounting of this now familiar story manages to excite like a novel, with pulse-pounding deadlines, superhero bureaucrats and evil villains (too many to count). He even opens his book with a lengthy "cast of characters." *BooksInShort* recommends his saga for its you-are-there view of what really happened on Wall Street – and, particularly, what really happened during one fateful weekend in September 2008.

Take-Aways

- The Wall Street crisis had its beginnings long before 2008 in easy credit and the myth of self-correcting markets.
- Linking home ownership to democracy, the US government created Fannie Mae and Freddie Mac as funding agencies to make it easier for Americans to buy homes.
- Subprime mortgages opened the dream of owning a home to those with weak credit.
- Subprime lending soared with financially innovative – and eventually financially disastrous – ways to package and sell those mortgages to investors.
- Collateralized mortgage obligations (CMOs) and collateralized debt obligations (CDOs) drew investors, gave banks extra funds to lend and made millions for Wall Street.
- Trouble loomed as subprime mortgages began defaulting, but their failure was inevitable.
- Massive exposure to crumbling CMOs and CDOs drained the fiscal system's liquidity.
- In one harrowing weekend, one financial firm after another veered toward collapse.
- The five main investment houses ended. Bought: Bear Stearns and Merrill Lynch. Bankrupt: Lehman Brothers. Turned into banks: Morgan Stanley and Goldman Sachs.
- The US rescued insurer AIG, setting the path for future bailouts to save the economy.

Summary

Black September

What is the best way to explain the events of September 2008? The world's financial markets spun out of control, banks failed, credit shut down, people lost their homes and governments shoveled billions at the problem. Many commentators see that month's bankruptcy of Lehman Brothers, a Wall Street institution, as the watershed moment of the crisis, but its causes date far back, as often is the case with momentous events in history.

> "Paradoxically, the more license that was given to markets, the more that Wall Street called on bureaucrats for help."

That September, less than 20 years had elapsed since the fall of the Berlin Wall, when the world celebrated the triumph of capitalism and free markets. Rational financial leaders had trumpeted the self-regulating nature of markets and disdained the need for any legal limitations, regarding them as unnecessary and disruptive to the markets' proper functioning. Bankers convinced themselves that their methods of determining risk and safeguarding against it augured a new financing paradigm: Taking on more debt, or overleveraging, was the way to go. Everyone, no matter his or her credit rating, could buy a home. Countrywide Financial would even advance the down payment as a "piggyback" loan on your mortgage.

> "To mortgage financiers, private capital was always preferable to federal control, but private capital with federal support was the best alternative of all."

The widely held conviction that free markets self-correct led to gradual banking deregulation. Bankers became the stars of the US economic story. "The Age of Markets" meant that traders determined foreign exchange rates and investment rates of return. Investment bankers and their clients decided which firms should merge, start up or dissolve. Financial engineers invented complex, new instruments to increase return or reduce risk – or in some cases, both. The Federal Reserve shared this blind faith in the markets' ability to take care of the nation's economic well-being; it believed booms and busts were no longer part of the financial equation. Then Lehman failed, opening "a trapdoor on Wall Street from which poured forth all the hidden demons and excesses, intellectual and otherwise, that had been accumulating during the boom." In 2008, the US government socialized the economy "on a scale that would have made Lenin smile."

The American Nightmare

In February 2006, mutual fund manager Robert L. Rodriguez had a dream – no, more of a nightmare. In it, a court called on him to account for his investments in Fannie Mae and Freddie Mac, the government-sponsored enterprises (GSEs) that were the mainstays of the US mortgage market. Backed by "implicit" government support, the "twins" guaranteed banks' housing loans, abetting the "democratic right" to home ownership. Few questioned the twins' solidity, integrity and federal backing, so global money managers blithely invested in their obligations. But Rodriguez's dream surfaced what he knew to be true in the waking world: Neither twin had issued audited financial statements in more than a year. Rodriguez saw the accounting problems as a red flag. Long before his dream, he knew the country was on a debt spree. By 2006, the cost of the American Dream was household indebtedness a third higher than household income – up from a post-World War II low of only 20% of disposable income. Financial firms similarly overleveraged themselves. Rodriguez figured that all these debts would eventually come home to roost, even if – or, maybe, because – the government had a hand in them. So, shortly after his dream, he sold all his firm's Fannie and Freddie bonds.

"Subprime Nation"

Before 1960, if you couldn't afford a one-third down payment or had "spotty credit" or wanted a second mortgage, you had only one housing alternative: renting. But the Beneficial Loan Society saw a market niche; in the 1960s it expanded from lending against household appliances (if you didn't pay, your friendly loan officer toted away your fridge) to lending against houses. With only 20% down, you could buy a home. Booms and busts over the next few decades saw such subprime lenders come and go, because lending to unqualified borrowers always has one outcome: default.

> "Eager lenders such as Countrywide and New Century were hailed as suburban Johnny Appleseeds, planting a mortgage in every backyard."

But the idea of an "ownership society," as President George W. Bush termed it, dies hard. Mozilo, the son of an immigrant, heard the call to "democratize credit." He appealed to that uniquely American populism of equal access to capital by popularizing adjustable rate mortgages (ARMs), including the "pay option ARM." With this ingenious loan, borrowers could opt to cut their monthly payments and let the difference accrue as debt. The pay option ARM turned the concept of a mortgage on its head: Instead of payments whittling down the loan, borrowers ended up in even more debt.

> "Real estate was the country's bedrock. But for many families the home had become something else: a casino."

The goal of opening credit markets to all – even the most suspect candidates – led to lowest common denominator banking. Once, proper credit assessments ensured the survival of each bank and the banking industry. But banks had loosened lending standards so much by 2006 that their common loan instruments included "NINA loans," ("no income, no asset" to qualify), "liar loans" and mortgages made on a "no-doc basis" (no supporting documentation required). Since everyone believed, like victims in a Ponzi scam, that mortgagees could always be refinanced in a growing market, very few lenders lost sleep over the quality of the loans they were underwriting.

> "The bankers learned to fool the system: to game the rating agencies, to bundle deadbeat mortgages into paper that was triple A and foist it on trusting clients."

Mortgage loan securitization, a very profitable invention by investment bankers, provided another impetus for rushing to extend loans to everyone (often, more than one each). Most housing lenders sold their loans to investment banks, which packaged masses of single mortgage loans into securities called collateralized mortgage obligations (CMOs). Then they recombined the CMOs into collateralized debt obligations (CDOs), or pools of CMOs. Rating agencies Moody's and Standard & Poor's bought the bankers' assurances that the core loans were diversified by borrowers and geography, and so were unlikely to default all at once. They affixed their highest ratings to tranches of these securities. Institutions with rules that permitted investing in only top-rated securities now could join the party. Thrilled to earn better-than-market returns on highly rated investments, investors didn't know or particularly care about the underlying mortgages.

> "Markets function on credit, and when investors become concerned about a cessation of credit, they are liable to panic."

Demand for CMOs and CDOs grew, so the supply of loans had to keep pace and lenders had to crawl deeper into the mire to find borrowers. Some investment banks wanted to assure their supply of loans by buying subprime loan originators. Early in 2007, Merrill Lynch senior vice president Pete Kelly paid a due diligence visit to a "no-money-down," subprime lender the firm was considering buying. He asked its top executives what kept them up at night. They said that "they slept like babies." Alarmed at their blasé attitude (and the Porsches in their parking lot), Kelly pulled the plug on the deal. "Prudent bankers worry about everything."

And the Wall (Street) Came Tumbling Down

Around the time of Bob Rodriguez's dream, subprime lenders began to notice signs of trouble. In March 2006, Mozilo emailed a Countrywide executive that the firm's no-money-down mortgages were "the most dangerous product in existence...there can be nothing more toxic." Still touting Countrywide to others, he "cynically" began selling his shares. Mortgage defaults began to rise, notably in "former boom towns" like Las Vegas. By October 2006, some "3% of subprime mortgages written earlier that year were...delinquent." Defaulters continued to pay credit cards bills and car loans, inverting the old banking truism that borrowers will stop paying all other debt before they risk foreclosure. Homeowners abandoned properties worth less than their mortgages.

> "It is arguable that no Treasury secretary, no Fed official, ever had to deal with so many crises in a single hour. Even during the Depression, events moved more slowly."

Suddenly CMOs and CDOs began dropping in value, as their underlying mortgages collapsed. The looming bad news at first paralyzed investors and then galvanized them into action. After Goldman Sachs "lost money for 10 days running" on mortgage securities, it began to sell, as did JPMorgan Chase. Two Bear Stearns hedge funds collapsed, losing $1.5 billion. Lehman Brothers, one of the banks most heavily invested in mortgage origination, packaging and sales, considered its options. CEO Richard Fuld chose not to act: He believed that cutting Lehman's mortgage exposure would be admitting that its profits came from a fortuitous market, not his prowess.

> "The dreaded chain reaction was becoming real."

By spring 2008, Bear Stearns itself had disappeared, taken over by JPMorgan at the instigation of the US Treasury and the Fed. Lehman was the next obvious target; its stock plummeted, sold short by hedge funds. Regulators repeatedly advised Lehman to raise capital and reduce its balance sheet. Fuld reached out to potential saviors, but every buyer declined to invest in Lehman, given its huge, then undeterminable, real estate exposure. Fuld continued to believe that the crisis would resolve and that the firm's tainted assets would recover, given enough time. Lehman executives came up with a scheme to spin off its suspect assets into a subsidiary (appropriately named "Spinco"). The market sensed that if Lehman faltered, the government would help rescue it or find a buyer, as it had with Bear. But neither Treasury Secretary Henry M. Paulson Jr. nor New York Fed President Timothy Geithner had such a plan; indeed, they were facing the specter of bailing out the twins, Fannie and Freddie, which they did on Sept. 5, 2008. The $100 billion that the US government invested in keeping the twins afloat outraged Main Street and began the public outcry over "handouts to wealthy bankers." In a scenario the most horrific disaster movie couldn't emulate, all these catastrophes came to a head one weekend in early September. Seeing that the twins' bailout wouldn't solve the mortgage crisis, the markets began to plunge again.

> "Having been widely criticized for allowing Lehman to fail, regulators were afraid to let any large institution go under, even as the most acute phase of the crisis receded."

Lehman's options were diminishing; potential investors kept dropping away and Moody's threatened to lower its ratings. On Friday evening, Sept. 12, Paulson corralled the top executives of 10 banks at the New York Fed. Their ostensible mission: develop a rescue financial package for Lehman. But a subset of the bankers worked on a "doomsday" team, charged with managing the fallout if Lehman failed. Fearing the worst, James L. Dimon, JPMorgan's CEO, advised his risk manager to prepare for the "chain reaction" collapses of Lehman, Merrill Lynch, Morgan Stanley and Goldman Sachs. The bankers also engaged in a Wall Street mating dance: Bank of America flirted with buying Lehman but bought Merrill Lynch. Fuld, who couldn't contact Bank of America's CEO, Ken Lewis, furiously declared, "I can't believe the son of a bitch won't return my calls."

> "While the bailouts were aimed at specific institutions, the Fed's actions to provide liquidity were aimed at salvaging the overall economy."

While the financial world waited for a response on Lehman, very few participants were thinking about the ticking time bomb that was American International Group (AIG). "The world's largest insurer," AIG had created a profitable niche by lending its AAA credit imprimatur to billions in CMOs and CDOs ($78 billion in CDOs alone). Former Chairman and CEO Robert Willumstad came out of retirement in June to lead AIG after it lost $18.5 billion. Clearly, if the rating agencies exercised their threat to strip AIG of its top scores, it would need up to $40 billion to cover collateral calls. By Willumstad's estimation, the firm would run out of cash by the following Wednesday. He walked to the Fed Saturday morning and tried to get Paulson's and Geithner's attention, but they were too busy trying to save Lehman.

> "The bailout policy – perhaps a necessary evil when the financial system was in extremis – was thus continued well beyond the banking emergency."

On Sunday, Warren Buffett begged off buying into Lehman, and a last-minute deal with Barclays fell through. The bankers had no rescue plan. Fuld even tried appealing to President Bush via his cousin, who ran Lehman's fund business. Paulson remained firm in his conviction that the government would not fund or guarantee Lehman. Its board voted that evening for the largest bankruptcy "in US history." A Lehman executive vented his fear and anger to a regulator: "You're unleashing the forces of evil."

"Aftershocks"

Lehman's bankruptcy sent shock waves around the world. On Monday, credit markets dried up, borrowing rates soared and funds fled into Treasury bills, driving their rates down to 0.22%. The stock market dropped 504 points, and mutual funds found that they'd "broken the buck" – their investments in Lehman's commercial paper pushed the net asset value of their shares to less than a dollar. Mutual fund companies appealed to the Fed. That morning, the same bankers, regulators and lawyers who had worked all weekend trying to save Lehman returned to the Fed to come up with a salvage plan for AIG, which by then estimated its hole to be closer to $85 billion. On Tuesday, hedge funds attacked Morgan Stanley and withdrew hundreds of millions in deposits. Paulson and Geithner, overwhelmed by the chaos unleashed by Lehman's bankruptcy, got an $85 billion government rescue approved for AIG. The first payment arrived on Tuesday at 9:30 p.m., hours before AIG would have run out of cash.

About the Author

Roger Lowenstein has written four books about Wall Street, including two bestsellers: *Buffett: The Making of an American Capitalist* and *When Genius Failed*. He writes for *SmartMoney* magazine, *The New York Times Magazine* and *The Wall Street Journal.*