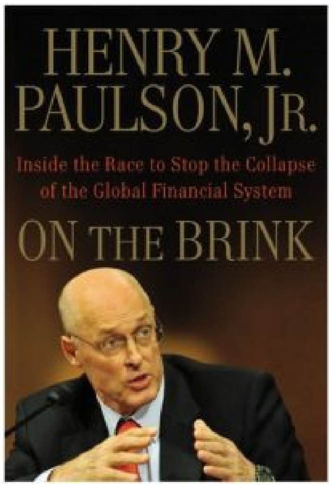

Book On the Brink

Inside the Race to Stop the Collapse of the Global Financial System

Henry M. Paulson
Business Plus, 2010
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Recommendation

If books about the 2008 financial collapse are starting to run together in your mind, rest assured that former Treasury Secretary Henry M. Paulson Jr.'s memoir is unique. In the first account by a high-ranking government official, Paulson lets out some juicy details. He describes the dry heaves and insomnia he suffered throughout the crisis, his pithy banter with President George W. Bush and his irritation with the ever-perky Sarah Palin. Even so, readers get the sense from his carefully scrubbed copy that Paulson is holding back. Alas, you may have expected as much – loose lips don't help one become Treasury secretary or CEO of Goldman Sachs (his former job). Still, this memoir is enlightening for his personal perspective. *BooksInShort* recommends it to taxpayers and policy makers seeking insight into the interactions of Washington and Wall Street.

Take-Aways

- In 2006, Henry "Hank" Paulson left Goldman Sachs to be George W. Bush's Treasury secretary.
- The financial crisis deepened in March 2008, as Bear Stearns nearly failed.
- Paulson, Federal Reserve Chair Ben Bernanke and New York Fed President Tim Geithner negotiated Bear Stearns' sale to JPMorgan Chase.
- On Sept. 4, 2008, Paulson began the government takeover of mortgage giants Fannie Mae and Freddie Mac.
- Paulson's efforts to arrange a sale of Lehman Brothers failed; it went bust on Sept. 15.
- The Fed lacked the authority to save Lehman, but it rescued AIG with $85 billion.
- With $1 trillion in toxic assets on banks' books, Paulson proposed a $700 billion capital injection known as the Troubled Asset Relief Program, or TARP.
- After Congress voted down TARP on Sept. 29, the Dow fell about 778 points, or 7%.
- Congress reconsidered and passed TARP on Oct. 3.
- The nine largest U.S. banks accepted a $125 billion federal investment, and TARP staved off a financial collapse.

Summary

Taking Down Fannie and Freddie

On Sept. 4, 2008, U.S. Treasury Secretary Henry "Hank" M. Paulson Jr. initiated the government's takeover of mortgage giants Fannie Mae and Freddie Mac. He intended to take control of them, fire their CEOs and pump $100 billion into each one. When he spoke to President George W. Bush about the plan, Paulson said, "The first sound [the two CEOs will] hear is their heads hitting the floor." He knew secrecy and surprise were crucial. Fannie and Freddie had strong supporters in Congress, in part because they often hired public sector insiders who wanted to join the more lucrative private arena. He feared that if word of a seizure leaked, opponents would slow the takeover, imperiling the U.S. financial sector and the global economy.

> "The pace of events during the financial crisis of 2008 was truly breathtaking."

Overleveraged and underregulated, the two companies were losing billions. Fannie's once-solid stock had plunged from $66 to $7.32 in a year. A few months earlier, Paulson had asked Congress for the authority to buy equity in Fannie and Freddie. Democrats loved the two controversial government-sponsored enterprises, but Republicans reviled them and were appalled that a Republican administration would shore them up with taxpayers' money. To Bush's credit, he put aside the ideological debate and focused on the pragmatic issue of keeping the financial system afloat. "It won't always look good, but we are going to do what we need to do to save the economy," Bush said. He faced another complication: Investors in Japan, China, Russia and elsewhere held more than $1 trillion in Fannie and Freddie debt; they could view a failure as expropriation of their money.

> "If we did not act immediately, Fannie and Freddie would...take down the financial system, and the global economy."

The two mortgage companies suffered the consequences of shaky business models and a regulatory scheme that seemed incapable of effective oversight. Jim Lockhart, head of Fannie's regulator, the Federal Housing Finance Agency, listed Fannie's shortcomings at a fateful Sept. 5 meeting with its CEO Daniel Mudd. Mudd felt the seizure was unjustified and he was angry, but Freddie CEO Richard Syron seemed "relieved." After the takeover, Paulson spoke to then-presidential candidates Barack Obama and John McCain. Obama struck Paulson as straightforward and well-versed in economic issues. McCain put running mate Sarah Palin on the phone. Her overly friendly approach and her fuzzy grasp of the situation irritated Paulson.

Being Henry

Paulson comes from a Republican family, but Democrats fill his personal life. His mother transformed from conservative to liberal in her later years. A staunch Bush opponent, she urged her son not to accept the nomination to Treasury secretary. "You'll be jumping on a sinking ship," she said. Paulson's wife, Wendy, and children, Merritt and Amanda, are all Democrats. Paulson's professional path began at Dartmouth College, where he did very well as a football offensive lineman despite competing against players 50 pounds heavier. He earned a Harvard M.B.A., served in the Naval Reserve Officers' Training Corps and worked in the Nixon White House in the early '70s, serving on the Domestic Council. In 1973, he became liaison to the Treasury. Watergate taught Paulson not to be overly impressed by his bosses' power. He joined Goldman Sachs' Chicago office, where he became known for his relentless work ethic. He even raced through reading bedtime stories to his kids so he could keep working. Paulson drove his staffers hard, demanding long hours. He figured they had to "learn how to say no." As he told them, "It's not your boss's job to figure out your life."

> "Seeing men who were one day on top of the world and in jail the next taught me an enduring life lesson: never be awed by title or position."

As Paulson excelled at Goldman, he gained more responsibility, taking charge of the bank's expansion into China, where he visited dozens of times from 1992 to 2006. In 1998, Goldman named Paulson and Jon Corzine [later New Jersey's governor] co-chairs and co-CEOs. Corzine stepped down in 1999. Paulson had mixed feelings about Wall Street's huge paychecks. He understood that money motivated bankers, but thought extravagant spending made his industry seem wasteful.

The Coming Crisis

When Bush asked Paulson to become Treasury secretary, Paulson was reluctant to leave Goldman, but he decided he couldn't turn down the call to duty. As he took office in July 2006, the housing bubble reached its dizzying heights. Home ownership was up to 69% from 64% just 12 years earlier. Nearly 20% of home loans were subprime mortgages, up from 5% in 1994. While Paulson was convinced that a financial crisis was coming, he missed seeing the trigger would be housing. So did other financial leaders, including Federal Reserve Chair Ben Bernanke. Wall Street and Washington elites didn't understand "the dreadful quality" of boom mortgages and underestimated how much homeowner behavior had changed. People once saw mortgage default as terrible. Now, with little or no equity in their properties, homeowners didn't hesitate to walk away from a loan. Wall Street repackaged mortgages as collateralized debt obligations (CDOs). As the boom continued, Wall Street wizards whipped up CDOs-squared, or derivatives of derivatives. Even the savviest investors had little idea how much risk had penetrated the fiscal system.

> "You spend so much time planning your work schedule and your career...make that kind of effort to manage your private life, too. Learn how to say no."

With the foreclosure crisis heating up, the 2008-2010 reset dates neared for about 1.8 million subprime adjustable-rate mortgages. Paulson asked his special assistant, Neel Kashkari, to come up with a relief plan. The result was the HOPE Now Alliance, which aimed to get struggling borrowers to talk to their loan servicers about their financial problems. Republicans derided HOPE Now as a homeowner bailout, and Democrats criticized it for not granting any money. These tensions built, with the odd effect of allying Paulson and Bush with Democrats, and often against congressional Republicans. As a practical matter, the program enabled hundreds of thousands of homeowners to get loan modifications or to refinance with fixed rates.

A Rescue for Bear Stearns

By March 2008, as the crisis accelerated, Bear Stearns neared failure. As investors fled, its cash fell from about $18 billion to "closer to $2 billion" in a week. This began months of sleepless nights for Paulson. On March 14, Paulson, Bernanke and New York Federal Reserve President Tim Geithner negotiated a stopgap: JPMorgan would stand behind Bear Stearns. But after examining its books, JPMorgan head James Dimon decided on Sunday that Bear's woes were too massive for JPMorgan to buy the investment bank. The market expected a bailout, and Paulson feared it would plunge without one. What could he do?

> "I was determined to properly align my interests with those of our shareholders. During my final three years as CEO, my bonus was paid entirely in stock."

The Fed and the Treasury had no authority to bail out an investment bank. But Geithner found a loophole letting the Fed make a loan, even to such a bank, under "exigent circumstances." To salvage the deal, the New York Fed agreed to put up $30 billion for toxic Bear assets JPMorgan didn't want. Dimon considered offering $4-$5 a share for Bear; Paulson and Geithner thought that was too high. With Bear on the brink, unnecessarily rewarding its shareholders seemed pointless. Paulson suggested $1-$2 as more realistic. Dimon offered $2 a share, or $236 million, a fraction of the some $20 billion Bear was worth in January 2007. Dimon later went to $10 a share. Bear's stockholders approved the deal on May 29. Reactions varied. Sen. Richard Shelby thought the feds should have let Bear fail. Sen. Jim Bunning called the rescue "socialism." Others saw it as a masterstroke that saved the financial system.

> "AIG's incompetence was stunning, but I didn't have time to be angry."

After Bear, Lehman Brothers was the weakest investment bank. In March 2008, Paulson told its prickly leader, CEO Dick Fuld, to shore up Lehman's capital position. As a favor to Fuld, Paulson called Warren Buffett, who was considering investing in Lehman. Paulson couldn't openly urge Buffett to invest, but he stressed the impact the billionaire's participation would have. Dubious, Buffett didn't invest. Fuld blamed short sellers for battering Lehman as its shares plummeted in months. Worried that Fuld didn't grasp how dire his plight was, Paulson urged him to talk to Bank of America (BofA) about a sale.

> "By early 2009, it was clear that our actions had prevented a meltdown."

The economic picture continued to darken. On July 11, the Federal Deposit Insurance Corporation closed IndyMac Federal Bank, the third-largest bank failure in U.S. history. With storm clouds swirling, Fuld talked to many suitors, including the Korea Development Bank, Deutsche Bank, Morgan Stanley and HSBC. He pondered spinning off Lehman's bad commercial real estate into an entity "unofficially" called Spinco and repeatedly asked Geithner and Paulson to put federal funds in it. They said no. Fuld shuffled top management and cut thousands of jobs.

> "Regulation failed to keep pace with rapid innovations in the markets – from the proliferation of increasingly complex and opaque products to the accelerating globalization of finance – with disastrous consequences."

In Lehman's final days, BofA and Barclays emerged as the two most realistic suitors. Bank of America CEO Ken Lewis was uncomfortable with Lehman's bad assets. On Sept. 11, Lewis first told Paulson BofA couldn't do the deal. Paulson asked Lewis what he'd need to do it and offered to broker an industry bailout like the one assembled for Long-Term Capital Management in the '90s. Barclays was still vying for Lehman, but the U.K.'s chancellor of the exchequer, Alistair Darling, called Paulson on Sept. 12 to express concerns about it. On Saturday, Sept. 13, Lewis reported that his BofA team kept finding more problems with Lehman's assets; he was unwilling to take on $40 billion of its most toxic investments. Barclays found more untouchable assets – $52 billion in commercial mortgages, land and Chrysler bonds. A Credit Suisse analysis reported that Lehman's assets were overvalued by tens of billions of dollars. Even as Paulson urged Lehman's competitors to fashion a rescue package, he saw the rampant contradictions. If the government forced private firms to bail out a competitor, where would it stop? Would investors have to calculate potential bailout costs when they bought shares in healthy firms? He determined that the Treasury lacked the authority to inject money into Lehman, and that even a Federal Reserve loan couldn't save it from the weight of its toxic assets. No one came to Lehman's rescue; on Sept. 15, 2008, it filed for the largest bankruptcy in U.S. history.

Stabilizing AIG

Next, the political debate turned to the collapsing insurance conglomerate AIG. Finance ministers from Germany and France called Paulson to urge a rescue, which McCain opposed. The Fed rescued AIG because it had a liquidity crunch, not a lack of capital like Lehman. Paulson leaned on McCain and Obama not to turn AIG into a populist campaign issue. AIG's national reach meant its failure would harm many people. Paulson and Bernanke proposed a bailout to lawmakers. When Barney Frank, chair of the House Committee on Financial Services, asked Bernanke where the Fed got the money, he said, "We have $800 billion." After the hearing, Paulson suffered dry heaves, his private affliction during the rest of the crisis.

> "Our regulatory system remains a hopelessly outmoded patchwork quilt built for another day and age."

Even with AIG stabilized, the world economy remained on dangerous footing. Stocks plunged, lenders wouldn't make loans and investors were so desperate for safety that the interest rate on three-month Treasury bills was negative. Paulson knew that U.S. banks, with $1 trillion in toxic assets, needed a major rescue package, but he couldn't ask Congress for that much. On Sept. 19 he proposed the $700 billion Troubled Asset Relief Program (TARP), which would let the Treasury buy mortgages and mortgage-backed securities. On Sept. 25, Washington Mutual suffered the U.S.'s largest bank collapse. Despite the turmoil, and Bush's and Paulson's support, TARP was a tough sell to Republicans. On Sept. 29, Congress voted 228-205 against it, though Democrats supported it. In its darkest day since October 1987, the Dow plunged some 778 points, or 7%. The market swoon caused Congress to rethink its vote, since taxpayers might blame it for the loss of their retirement accounts. On Oct. 3, it passed TARP by 263 to 171.

> "I don't wake up mornings wishing that I were still Treasury secretary. For one thing, I'm finally getting a good night's sleep again."

Paulson and his staff then had to determine how best to spend the money. Paulson believed it should go to healthy institutions, not failing banks. He considered matching the private capital banks raised, buying common stock (but decided against that because the voting power it would convey smacked of nationalization), or buying preferred shares without voting rights but with higher dividends. On Oct. 11, Buffett called to suggest buying preferred shares and requiring a dividend of 5%-6% on federal purchases. On Oct. 13, the nine largest U.S. banks agreed to a $125 billion capital infusion from the government. Nearly 700 healthy banks eventually participated. TARP staved off the collapse of global markets. The crisis taught several lessons, among them: The U.S.'s low savings rate and the high savings rates in China and Japan create unsustainable "imbalances." The U.S. regulatory structure lags the markets. Bank CEOs ignored liquidity levels. And the biggest financial institutions were dangerously large.

About the Author

Henry M. Paulson Jr. served as President George W. Bush's Secretary of the Treasury from July 2006 to January 2009. He stepped down as CEO of Goldman Sachs to take that office.