



Thursday, Sep. 18, 2008

How Financial Madness Overtook Wall Street

By Andy Serwer and Allan Sloan

If you're having a little trouble coping with what seems to be the complete unraveling of the world's financial system, you needn't feel bad about yourself. It's horribly confusing, not to say terrifying; even people like us, with a combined 65 years of writing about business, have never seen anything like what's going on. Some of the smartest, savviest people we know — like the folks running the U.S. Treasury and the Federal Reserve Board — find themselves reacting to problems rather than getting ahead of them. It's terra incognita, a place no one expected to visit.

Every day brings another financial horror show, as if Stephen King were channeling Alan Greenspan to produce scary stories full of negative numbers. One weekend, the Federal Government swallows two gigantic mortgage companies and dumps more than \$5 trillion — yes, with a *t* — of the firms' debt onto taxpayers, nearly doubling the amount Uncle Sam owes to his lenders. While we're trying to get our heads around what amounts to the biggest debt transfer since money was created, [Lehman Brothers goes broke](#), and Merrill Lynch feels compelled to shack up with Bank of America to avoid a similar fate. Then, having sworn off bailouts by letting Lehman fail and wiping out its shareholders, the Treasury and the Fed reverse course for [an \\$85 billion rescue of creditors and policyholders of American International Group \(AIG\)](#), a \$1 trillion insurance company. Other once impregnable institutions may disappear or be gobbled up.

The scariest thing to average folk: one of the nation's biggest money-market mutual funds, the Reserve Primary, announced that it's going to give investors less than 100 cent on each dollar invested because it got stuck with Lehman securities it now considers worthless. If you can't trust your money fund, what can you trust? To use a technical term to describe this turmoil: *yechhh!*

There are two ways to look at this. [There's Wall Street's way](#), which features theories and numbers and equations and gobbledygook and, ultimately, rationalization (as in, "How were we supposed to know that people who lied about their income and assets would walk away from mortgages on houses in which they had no equity? That wasn't in our computer model. It's not our fault"). Then there's the right way, which involves asking the questions that really matter: How did we get here? How do we get out of it? And what does all this

mean for the average joe? So take a deep breath and bear with us as we try to explain how financial madness overtook not only Wall Street but also Main Street. And why, in the end, almost all of us, collectively, are going to pay for the consequences.

[See the winners and losers of the Wall Street mess here.](#)

Going forward, there's one particularly creepy thing to keep in mind. In normal times, problems in the economy cause problems in the financial markets because hard-pressed consumers and businesses have trouble repaying their loans. But this time — for the first time since the Great Depression — problems in the financial markets are slowing the economy rather than the other way around. If the economy continues to spiral down, that could cause a second dip in the financial system — and we're having serious trouble dealing with the first one.

The Roots of the Problem

How did this happen, and why over the past 14 months have we suddenly seen so much to fear? Think of it as payback. Fear is so pervasive today because for years the financial markets — and many borrowers — showed no fear at all. Wall Streeters didn't have to worry about regulation, which was in disrepute, and they didn't worry about risk, which had supposedly been magically whisked away by all sorts of spiffy nouveau products — derivatives like credit-default swaps. (More on those later.) This lack of fear became a hothouse of greed and ignorance on Wall Street — and on Main Street as well. When greed exceeds fear, trouble follows. Wall Street has always been a greedy place and every decade or so it suffers a blow resulting in a bout of hand-wringing and regret, which always seems to be quickly forgotten.

This latest go-round featured hedge-fund operators, leveraged-buyout boys (who took to calling themselves "private-equity firms") and whiz-kid quants who devised and plugged in those new financial instruments, creating a financial Frankenstein the likes of which we had never seen. Great new fortunes were made, and with them came great new hubris. The newly minted masters of the universe even had the nerve to defend their ridiculous income tax break — much of the private-equity managers' piece of their investors' profits is taxed at the 15% capital-gains rate rather than at the normal top federal income tax rate of 35% — as being good for society. ("Hey, we're creating wealth — cut us some slack.")

The Root of the Problems

Warren Buffett, the nation's most successful investor, back in 2003 called these derivatives — which it turned out almost no one

understood — "weapons of financial mass destruction." But what did he know? He was a 70-something alarmist fuddy-duddy who had cried wolf for years. No reason to worry about wolves until you hear them howling at your door, right?

Besides a few prescient financial sages, though, who could have seen this coming in the fall of 2006, when things were booming and the world was awash in cheap money? There was little fear of buying a house with nothing down, because housing prices, we were assured, only go up. And there was no fear of making mortgage loans, because what analysts call "house-price appreciation" would increase the value of the collateral if borrowers couldn't or wouldn't pay. The idea that we'd have house-price depreciation — average house prices in the top 20 markets are down 15%, according to the S&P Case-Shiller index — never entered into the equation.

As for businesses, there was money available to buy corporations or real estate or whatever an inspired dealmaker wanted to buy. It was safe too — or so Wall Street claimed — because investors worldwide were buying U.S. financial products, thus spreading risk around the globe.

Now, though, we're seeing the downside of this financial internationalization. Many of the mortgages and mortgage securities owned or guaranteed by [Fannie Mae and Freddie Mac](#) were bought by foreign central banks, which wanted to own dollar-based securities that carried slightly higher interest rates than boring old U.S. Treasury securities. A big reason the Fed and Treasury felt compelled to bail out Fannie and Freddie was the fear that if they didn't, foreigners wouldn't continue funding our trade and federal-budget deficits.

You've heard, of course, that subprime mortgages — *subprime* is Wall Street's euphemism for *junk* — are where the problems started. That's true, but the problems have now spread way beyond them. Those predicting that the housing hiccup wouldn't be a big deal — what's a few hundred billion in crummy mortgage loans compared with a \$13 trillion U.S. economy or a \$54 trillion world economy? — failed to grasp that possibility. It turned out that Wall Street's greed — and by *Wall Street*, we mean the world of money and investments, not a geographic area in downtown Manhattan — was supplemented by ignorance. Folks in the world of finance created, bought, sold and traded securities that were too complex for them to fully understand. (Try analyzing a CDO-squared sometime. Good luck.)

For an example in our backyard, consider Lehman Brothers. Lehman was so flush, or at least felt so flush, that in May 2007 it sublet 12 prime midtown-Manhattan floors of the Time & Life Building — across the street from Lehman headquarters — from Time Inc., which publishes this magazine. Lehman signed on for \$350 million over 10 years. (It's not clear what kind of hit, if any, Time Inc. will now

face.)

Lehman's fall shows the downside of using borrowed money. Even though Lehman has a 158-year-old name, it's actually a 14-year-old company that was spun off by American Express in 1994. AmEx had gobbled it up 10 years earlier, and it wasn't in prime shape when AmEx spat it out. To compensate for its relatively small size and skinny capital base, Lehman took risks that proved too large. To keep profits growing, Lehman borrowed huge sums relative to its size. Its debts were about 35 times its capital, far higher than its peer group's ratio. And it plunged heavily into real estate ventures that cratered.

Here's how leverage works in reverse. When things go well, as they did until last year, Lehman is immensely profitable. If you borrow 35 times your capital and those investments rise only 1%, you've made 35% on your money. If, however, things move against you — as they did with Lehman — a 1% or 2% drop in the value of your assets puts your future in doubt. The firm increasingly relied on investments in derivatives to produce profits, in essence creating a financial arms race with competitors like Goldman Sachs. Even though the Fed had set up a special borrowing program for Lehman and other investment banks after the forced sale of Bear Stearns to JPMorgan Chase in March, the market ultimately lost faith in Lehman. So out it went.

Uncle Sam Steps Back In

The market lost faith in AIG too, but the government was forced to save it. A major reason is that AIG is one of the creators of the aforementioned credit-default swaps. What are those, you ask? They're pixie-dust securities that supposedly offer insurance against a company defaulting on its obligations. If you buy \$10 million of GM bonds, for instance, you might hedge your bet by buying a \$10 million CDS from AIG. In return for that premium — which changes day to day — AIG agrees to give you \$10 million should GM have an "event of default" on its obligations.

But as a way to make sure that swap meisters can make good on their obligations, they have to post collateral. If their credit is downgraded — as was the case with AIG — they have to post more collateral. What put AIG on the brink was that it had to post \$14 billion overnight, which of course it didn't have lying around. Next week, the looming downgrades might have forced it to come up with \$250 billion. (No, that's not a typographical mistake; it's a real number.) Hence the action. If AIG croaked, all the players who thought they had their bets hedged would suddenly have "unbalanced books." That could lead to firms other than AIG failing, which could lead to still more firms failing, which could lead to what economists call "systemic failure." Or, in plain terms, a financial death spiral in which firms suck one another into the abyss.

AIG, like Lehman, was ultimately done in by credit-rating agencies, of all things. The main credit raters — Moody's and Standard & Poor's — had blithely assigned top-drawer AAA and AA ratings to all sorts of hinky mortgage securities and other financial esoterica without understanding the risks involved. Would you know how to rate a collateralized loan obligation? Or commercial-mortgage-backed securities? Sophisticated investors took Moody's and S&P's word for it, and it turned out that the agencies didn't know what they were doing. Credit raters, who claim to offer only opinions, are party to Wall Street's cycles too. At the beginning, they're far too lenient with borrowers, who are the ones who pay their rating fees. Then, after a couple of embarrassments — remember Enron and WorldCom? — the raters tighten up, maybe too much. Then memory fades, and the cycle repeats.

What doomed AIG was the rating agencies' decision — they had suddenly awakened to AIG's problems — to sharply downgrade the firm's securities. That gave AIG no time to react, no time to raise more capital, no more time to do anything else but beg for help. Because AIG is in a much scarier situation than Lehman — the insurer has assets of \$1 trillion, more than 70 million customers and intimate back-and-forth dealings with many of the world's biggest and most important financial firms — Uncle Sam felt that it had no choice but to intervene.

Right before the markets began to unravel last year, Lloyd Blankfein, chief executive of Goldman Sachs, presciently quipped that he hadn't "felt this good since 1998," referring to the Wall Street wipeout precipitated that year by Russia's defaulting on its ruble debt. Blankfein argued that confidence in global markets had built up to a dangerously giddy level and that investors weren't being compensated for assuming outside risk in securities like esoteric bonds and Chinese stocks. Blankfein was right, of course, but even he wasn't paranoid enough. [Though Goldman stands, along with Morgan Stanley, as one of the last two giant U.S. investment banks not to collapse](#) (as Lehman and Bear Stearns have) or be sold (à la Merrill Lynch), Goldman too has been pummeled. The firm's quarterly profit plunged 70% — results considered to be relatively good. While analysts generally believe that Goldman and Morgan Stanley will survive the meltdown, that view is not unanimous. Says doomster New York University economics professor Nouriel Roubini: "They will be gone in a matter of months as well. It's better if Goldman or Morgan Stanley find a buyer, because their business model is fundamentally flawed." Both firms would beg to disagree, but their stock prices have been hammered.

All of us are now paying the price for Wall Street's excesses. Some of the cost is being paid by prudent people, like retirees who have saved all their life. They're now getting ridiculously low rates of 2% or so on their savings because the Federal Reserve has cut short-term rates in an attempt to goose the economy and reassure financial markets. Taxpayers are going to get stuck too. By the

estimate of William Poole, former head of the St. Louis Fed, bailing out the creditors of the two big mortgage firms, Fannie Mae and Freddie Mac, could cost taxpayers \$300 billion. Think of that as about a year and a half in Iraq.

Didn't the folks on Wall Street, who are nothing if not smart, know that someday the music would end? Sure. But they couldn't help behaving the way they did because of Wall Street's classic business model, which works like a dream for Wall Street employees (during good times) but can be a nightmare for the customers. Here's how it goes. You bet big with someone else's money. If you win, you get a huge bonus, based on the profits. If you lose, you lose someone else's money rather than your own, and you move on to the next job. If you're especially smart — like Lehman chief executive Dick Fuld — you take a lot of money off the table. During his tenure as CEO, Fuld made \$490 million (before taxes) cashing in stock options and stock he received as compensation. A lot of employees, whose wealth was tied to the company's stock, were financially eviscerated when Lehman bombed. But Fuld is unlikely to show up applying for food stamps.

Fuld is done with the grueling job of trying to stave off financial crisis. Not so for regulators, of course. It's difficult to imagine the pressure and stress. Key players such as Treasury Secretary Hank Paulson and New York Fed chief Tim Geithner have been working around the clock for weeks now, putting out fire after fire. Besides having to comprehend and solve the mind-bending financial woes of some of the world's biggest companies, they are also briefing and seeking counsel from CEOs of the surviving companies, never mind President George W. Bush and the two presidential candidates, plus central bankers from around the globe.

Where Do We Go from Here?

There's no question that the crisis has gone so deep that it cannot be halted by one stroke. Banks and other financial companies around the globe are struggling to pull themselves out of this mess. Rebuilding will take time, vast amounts of money and constant attention. Sooner or later, the hundreds of billions (or trillions) of dollars that the Fed and other central bankers are throwing into the markets will stabilize things. Sooner or later, housing prices will stop falling because no financial trend continues forever.

Given that this is a political year and *change* is the buzzword, how do Barack Obama and John McCain intend to see us out of this mess? Good question. We don't know, and it's not at all clear that they've thought about it in greater than sound-bite depth.

Obama has called for increased regulation, which seems like a no-brainer, but he hasn't articulated many specifics. Meanwhile, McCain has talked about ending "wild speculation" and railed against Wall Street greed. Well, duh. Know anyone who is in favor of naked

greed? Whoever wins will face a massive job of righting the financial ship and restoring confidence that has been badly shaken. The next President will have to cast away partisan predispositions and add the just-right measure of regulation and oversight to the mix. As Treasury Secretary (and former Goldman Sachs chief executive) Paulson recently said, "Raw capitalism is dead."

Whatever the politicians do, we as a society are going to be poorer than we were. We've lost credibility with foreigners; they will be less likely than before to lend us endless amounts of cheap money. Will that ultimately lead to higher borrowing costs? It's hard to see how it won't.

Coping in this new world will require adjustments by millions of Americans. We all will have to start living within our means — or preferably below them. If you don't overborrow or overspend, you're far less vulnerable to whatever problems the financial system may have. And remember one other thing: the four most dangerous words in the world for your financial health are "This time, it's different." It's never different. It's always the same, but with bigger numbers.

(Additional photo credits -- Paulson: AP; AIG Ticker: Andrew Harrer / Bloomberg / Landov; Lehman: Getty; Federal Reserve Bank of New York: AP; Foreclosure: AP; AIP sign: Getty; Dow Jones: AP)

[See the winners and losers of the Wall Street mess here.](#)

 Click to Print

Find this article at:

<http://www.time.com/time/business/article/0,8599,1842123,00.html>

Copyright © 2008 Time Inc. All rights reserved. Reproduction in whole or in part without permission is prohibited.

[Privacy Policy](#) | [Add TIME Headlines to your Site](#) | [Contact Us](#) | [Customer Service](#)

Wall Street is both a physical location and a metonymy for investing. Take a look at the function and role of Wall Street and how it works. Wall Street is also a metonymy, or figure of speech, for capital market finance. The term is frequently used to describe a person, institution, or activity tied to high finance and banking. For example, American Century Investments is an asset management company in Kansas City, Mo., that oversees \$170 billion, mostly through mutual funds and institutional relationships. It is located in the heart of the Midwest, surrounded by plains a few miles out from its headquarters at the Country Club Plaza. How to solve Wall Street's methodically planned, legal deception. Let's begin with a story. In the early 1990s, I managed a portfolio for a successful hedge-fund. You may know those fees and expenses exist somewhere in the financial ether, but I've never spoken to an investor who can tell me how much they paid for the services of their mutual funds. Do you know how much you've paid for investments in terms of dollars and cents? Click To Tweet. There's Wall Street's way, which features theories and numbers and equations and gobbledeygook and, ultimately, rationalization (as in, "How were we supposed to know that people who lied about their income and assets would walk away from mortgages on houses in which they had no equity? That wasn't in our computer model." So take a deep breath and bear with us as we try to explain how financial madness overtook not only Wall Street but also Main Street. And why, in the end, almost all of us, collectively, are going to pay for the consequences. Full article >>. COVER: How Financial Madness Overtook Wall Street - For years the financial markets roared along as if there were nothing to fear. Now it's payback time--and all of us will be feeling the pain WORLD: Death in Birth - The number of women in poor countries who die in childbirth has barely changed in two decades and this despite a host of medical breakthroughs. How can the incidence of this devastating human tragedy be reduced? RELIGION: The Bible Goes Green for the Prius Age - A color-coded Bible is geared to environmentalists TECHNOLOGY: The Chevy Volt: GM's Huge Bet on the How Does Wall Street Have Such an Impact? Wall Street affects the U.S. economy in a number of ways, the most important of which are as follows: Wealth Effect: Buoyant stock markets induce a "wealth effect" in consumers, although some prominent economists assert that this is more pronounced during a real estate boom than it is during an equity bull market. Wall Street consists of the largest stock exchanges, the largest financial firms, and employs thousands of people. As the trading hub of the world's biggest economy, Wall Street has an enduring impact not just on the American economy, but also on the global one. Article Sources.