

Boulder Public Library

And Then the Roof Caved In

*How Wall Street's Greed
and Stupidity Brought
Capitalism to Its Knees*

David Faber



WILEY

John Wiley & Sons, Inc.

financial world that we grew up with. That world ended in September 2008 and we've been dealing with the consequences ever since.

On some occasions, I find myself suppressing a desire to stop my report and get up and start shouting at the camera, "Do you have any idea what has happened to our financial system? Do you realize it has been turned upside-down and inside-out and no one is quite sure of anything anymore?" Because it's true. The ground has been shifting beneath the financial world we once knew and no one is quite certain what the landscape will look like when it stops shifting.

Each day seems to bring new pronouncements about what U.S. financial institutions can and cannot do. At this very moment, scores of executives at our nation's banks are scouring the fine print in an economic stimulus bill that recently became law and are trying to determine how much money they can pay themselves each year. The U.S. government is keeping the financial system afloat through a series of support mechanisms the likes of which our financial markets have never seen, and so our elected officials seem to be in more control of these companies than their own leaders.

Amazingly, the United States is in a lot less trouble than much of the rest of the world. We are less exposed to the radical economic deterioration taking place than many of our trading partners, who are dealing with large budget deficits, failing banks, and a tax base too small to help bail them out.

Countries in Eastern Europe that feasted for years on cheap loans from banks in Western Europe now find themselves unable to pay back the money. Their economies—which were based on producing goods for the U.S. market—have collapsed.

Now there is a real fear that a cascade of sovereign defaults in Eastern Europe will overwhelm Western Europe's banks. And if those banks fail, can their governments bail them out in the same way the United States has saved its banks?

While it has tried to avoid "nationalizing" financial institutions, the U.S. government was forced to take ownership of three of the largest financial institutions in the world. AIG, Fannie Mae, and Freddie Mac seem likely to compete with each other for the title of the largest loss in financial history before this crisis ends. At present, AIG alone has cost the

U.S. taxpayer \$162 billion. It has been the largest recipient by far of government money. All those credit default swaps it wrote with nary a care in the world have cost us all. It makes one wonder whether we might have been better off just letting it fail and dealing with the consequences since many of those same consequences seem to have been delivered anyway.

The U.S. government saved Citigroup from near-certain collapse by guaranteeing hundreds of billions of its loans to consumers and corporations, and that still wasn't enough to keep it propped up. Now, taxpayers own 36 percent of the once-mighty bank after coming to its rescue for a third time.

The largest single component of the loan portfolio the U.S. taxpayer is now standing behind for Citigroup is mortgage loans, about \$154 billion of them. If you want a sign this crisis is far from over, you need look no further than Citigroup's decision to include all those mortgages in the pool of assets the government is guaranteeing. If Citigroup thought they were money-good, they wouldn't be there. A similar, though smaller (roughly \$100 billion), guarantee has also been provided to Bank of America, another of the largest lending institutions in our country.

Lazard Freres is now the largest investment bank in the United States. That's because Morgan Stanley and Goldman Sachs, after watching their former competitors at Lehman Brothers and Bear Stearns collapse, ran to the shelter provided by the bank holding company structure. It's not clear what the new model for making money is at these companies, now that the old model—reliance on excessive amounts of leverage to generate rich returns—appears dead. As the recipient of billions in government money and under the now-strict supervision of the Federal Reserve, it's hard to imagine these companies will be allowed to take the kind of risk they did in the past.

These days, of course, none of them are interested in taking risk. They are most interested in avoiding it. After years of lending money to consumers and corporations with fewer and fewer strings attached, our banks are quickly backpedaling. Standards that might recently have seemed quaint are back in fashion.

The banks raised money furiously in 2008 until there were simply no private investors left to tap. That's a key problem these days. Banks cannot raise capital at almost any price. They can't even sell debt. As

of this writing, the only unsecured debt sold for months in the entire banking sector that was not backed by the government has been a paltry \$2 billion raised by Goldman Sachs.

With no one else to turn to, the banks have turned to the government. While more than \$700 billion of our taxpayer money has been “lent” to financial institutions both large and small in an attempt to shore up their balance sheets, it is a simple fact that at this moment many of the most important financial institutions in this country, just like Citigroup, remain technically insolvent. If they were forced to sell their assets at current market prices, there is no way their tangible equity would be enough to withstand the massive losses they would suffer as a consequence of those sales.

They are dead men walking—hoping they can walk far enough to reach a point beyond the current crisis when profits will be restored along with their financial viability. It may be a long walk.

At present count, the world’s banks have lost \$1.2 trillion since the credit crisis began in the summer of 2007. Most of those losses are directly related to the collapse of the mortgage market in the United States. The rest came as a result of the crisis brought on by that collapse. One might hope that more than a trillion dollars’ worth of losses would be enough—that it would represent the necessary writedowns on all the mortgages and mortgage-backed securities made from those mortgages and CDOs constructed from those mortgage-backed securities and credit default swaps written to provide insurance on those mortgage-backed securities and CDOs. But it won’t be.

The decline in lending standards detailed in the pages of this book may be neatly summarized as the *subprime problem*. But as you have read, it was not confined to that subset of the mortgage market. While notices of defaults (which are sent after a homeowner misses three or four payments) have subsided for subprime loans, they have started to surge in the rest of the mortgage market. That’s because during the boom many prime borrowers were not really prime.

Who better to explain than Kyle Bass:

Imagine you’re a subprime borrower in 2004 and you refinanced your loan in 2005 into a bigger loan so you could cash

Out some money. So if you cash out and refinance, your credit score goes up because you just paid off a huge loan. So your first loan might have been subprime, but on your next loan you're a prime borrower.

In a market where housing prices rose, those borrowers might still be considered prime. But with prices down they are nothing more than a subprime tenant in a house that's worth less than their mortgage.

While subprime mortgage debt totals about \$1.2 trillion and alt-A mortgages around \$1.5 trillion, the prime mortgage market totals \$10 trillion. Even small percentage losses in that market add up to huge numbers. And they are coming.

Junbo prime mortgages, which are mortgages above the amount that Fannie and Freddie will buy, have seen a surge in delinquencies. Securitizations comprised of these mortgages are seeing delinquency rates above 7 percent. And delinquencies among prime borrowers whose mortgages are eligible for sale to Fannie and Freddie are also surging.

The rating agencies, after owing up to the error of their ways in July 2007, have been assaulting every known securitization made up of mortgages ever since. In the summer of 2008, S&P yet again revised its loss assumptions on every type of mortgage securitization. The other rating agencies have done the same, taking securities they once rated triple-A to levels that make them the junk they always were.

It may get worse before it gets better, because housing prices are still falling. The economic forecasting team at Goldman Sachs recently did a study of housing busts in countries that belong to the Organization for Economic Cooperation and Development. They studied 24 so-called housing busts that have taken place since the 1970s. Each saw at least a 15 percent decline in real home prices (after inflation) with the average decline over 30 percent. Kyle Bass believes we are only two years into a six-year bottoming process in which prices will fall an average of 35 percent nationwide from peak to trough.

The banks may have already written off \$1.2 trillion, but economists at the International Monetary Fund believe we have at least another trillion dollars' worth of writedowns to come. It's not just mortgages and mortgage-related products any longer. With a brutal recession in

full swing; loans of all types to consumers and businesses are bound to suffer. When one thinks of a company such as Bank of America with \$690 billion in consumer-related loans and commercial loans of \$337 billion, it's easy to understand why it may be on the dole for a while longer.

I recently ran into Meg Whitman, the former CEO of eBay, who is running for governor of California. Meg is a first-class lady—smart, focused, and decent. Why in the world she wants to run the state of California is beyond me. Meg told me that in the Inland Empire of California, one in every four homes is in foreclosure. Many of the homes built in those former cow pastures now sit empty, their lawns no longer cared for and a NO TRESPASSING sign pasted to the front window.

Joe and Barbara Dunkley, who bought early in the boom and sold at its peak, were among the lucky ones. They made a profit of \$250,000 on a house they had paid \$300,000 for only a couple of years earlier. But the Dunkleys decided to stay in the Inland Empire and rent a home. Sure enough, the home they rented was foreclosed on. It seems that even the lucky ones haven't been able to escape.

Back on Wall Street, there has also been no escape. Tens of thousands of people have lost their jobs at the banks that helped create the economic crisis and each day more jobs are cut. The collateral damage has been even greater. Americans watched their retirement savings vanish as the equity markets plummeted in 2008 and early 2009, while their net worth also declined due to the precipitous fall in home values.

There was nowhere to hide. Not in stocks or bonds or hedge funds or private equity. Although there have been a handful of stars such as Kyle Bass, the vast multitude of professional investors got it wrong.

And yet there is still a hope on Wall Street that while things will be different for a period of time, they won't change for all time. And when I talk about *change*, I am referring specifically to *compensation*—the compensation of the people who work at the banks that fueled the mortgage madness that consumed the world's economy; the compensation of the private equity bankers who thrived on the cheap-and-plentiful debt they could use to buy up enormous and well-known companies such as Hilton Hotels and Harrah's and are now watching some of those companies teeter on the brink of insolvency; the compensation of the hedge fund managers who, despite losing 20 or 30 or

40 percent of their clients' money in one year, made tens of millions in years past, notwithstanding an ultimate track record that left many of their longtime investors lucky if they came out even.

They know there may be a pause in the obscene sums they were able to command. These are not stupid people. They sense the *zeitgeist*. But they also know that memories may be too short and the will of shareholders and limited partners too weak to deny them the riches they desire for too long.

Many of them are my friends. They are decent people. They are generous people. These are people who went to Wall Street because they knew that if they succeeded they would make a lot of money. And there is nothing wrong with that. But now they are complaining that they had nothing to do with causing this collapse and are still being held to account for it. And they are right; it doesn't seem completely fair. But the waiter who loses his job because the restaurant where he works serves awful food and closes as a result can say the same thing. Sometimes, that's just the way it is.

The toll for Americans of more modest means builds every day. Alan Greenspan told me the only thing he could have done to stop the housing bubble was to have raised interest rates so high that the housing bubble would have been decisively popped. "We could have clamped down on the American economy, generated a 10 percent unemployment rate and I will guarantee you we would not have had a housing boom, a stock market boom, or indeed a particularly good economy either," explained the former Fed chairman. Greenspan believes popping the housing bubble was an untenable solution that would have created an even bigger problem. But these days I find myself wondering whether that is true. Many expect the unemployment rate will exceed 10 percent sometime in 2009 or 2010.

Here in New York City, it is a strange time. There is foreboding. The restaurants are still often full and the streets still bustling. But there's a feeling in the air reminiscent of what it must have been like in Paris before the German army came storming in. We are all waiting for a change that seems inevitable given the carnage on Wall Street, the jobs and riches that have been washed away in the deluge of losses. No one is quite sure what that change will bring.