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ROSS SORKIN

INSIDE THE BATTLE TO
SAVE WALL STREET

TOO BIG TO FAIL

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ECONOMIST



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'Andrew Ross Sorkin pens what may be the definitive history of the banking crisis' *Atlantic Monthly*

'Sorkin has succeeded in writing the book of the crisis, with amazing levels of detail and access' *Reuters*



ABOUT THE AUTHOR

Andrew Ross Sorkin is the award-winning chief mergers and acquisitions reporter for *The New York Times*, a columnist, and assistant editor of business and finance news. He has won a Gerald Loeb Award, the highest honour in business journalism, and a Society of American Business Editors and Writers Award. In 2007, the World Economic Forum named him a Young Global Leader.





TOO BIG TO FAIL

Inside the Battle to Save Wall Street

Andrew Ross Sorkin



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To my parents, Joan and Larry, and my loving wife, Pilar



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Size, we are told, is not a crime. But size may, at least, become noxious by reason of the means through which it was attained or the uses to which it is put.

— Louis Brandeis, *Other People's Money: And How the Bankers Use It*, 1913





AUTHOR'S NOTE

This book is the product of more than five hundred hours of interviews with more than two hundred individuals who participated directly in the events surrounding the financial crisis. These individuals include Wall Street chief executives, board members, management teams, current and former U.S. government officials, foreign government officials, bankers, lawyers, accountants, consultants, and other advisers. Many of these individuals shared documentary evidence, including contemporaneous notes, e-mails, tape recordings, internal presentations, draft filings, scripts, calendars, call logs, billing time sheets, and expense reports that provided the basis for much of the detail in this book. They also spent hours painstakingly recalling the conversations and details of various meetings, many of which were considered privileged and confidential.

Given the continuing controversy surrounding many of these events—several criminal investigations are still ongoing as of this writing, and countless civil lawsuits have been filed—most of the subjects interviewed took part only on the condition that they not be identified as a source. As a result, and because of the number of sources used to confirm every scene, readers should not assume that the individual whose dialogue or specific feeling is recorded was necessarily the person who provided that information. In many cases the account came from him or her directly, but it may also have come from other eyewitnesses in the room or on the opposite side of a phone call (often via speakerphone), or from someone briefed directly on the conversation immediately afterward, or, as often as possible, from contemporaneous notes or other written evidence.

Much has already been written about the financial crisis, and this book has tried to build upon the extraordinary record created by my esteemed colleagues in financial journalism, whose work I cite at the end of this

volume. But what I hope I have provided here is the first detailed, moment-by-moment account of one of the most calamitous times in our history. The individuals who propel this narrative genuinely believed they were—and may in fact have been—staring into the economic abyss.

Galileo Galilei said, “All truths are easy to understand once they are discovered; the point is to discover them.” I hope I have discovered at least some of them, and that in doing so I have made the often bewildering financial events of the past few years a little easier to understand.

THE CAST OF CHARACTERS AND THE COMPANIES THEY KEPT

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Too Big to Fail





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PROLOGUE

Standing in the kitchen of his Park Avenue apartment, Jamie Dimon poured himself a cup of coffee, hoping it might ease his headache. He was recovering from a slight hangover, but his head really hurt for a different reason: *He knew too much.*

It was just past 7:00 a.m. on the morning of Saturday, September 13, 2008. Dimon, the chief executive of JP Morgan Chase, the nation's third-largest bank, had spent part of the prior evening at an emergency, all-hands-on-deck meeting at the Federal Reserve Bank of New York with a dozen of his rival Wall Street CEOs. Their assignment was to come up with a plan to save Lehman Brothers, the nation's fourth-largest investment bank—or risk the collateral damage that might ensue in the markets.

To Dimon it was a terrifying predicament that caused his mind to spin as he rushed home afterward. He was already more than two hours late for a dinner party that his wife, Judy, was hosting. He was embarrassed by his delay because the dinner was for the parents of their daughter's boyfriend, whom he was meeting for the first time.

"Honestly, I'm never this late," he offered, hoping to elicit some sympathy. Trying to avoid saying more than he should, still he dropped some hints about what had happened at the meeting. "You know, I am not lying about how serious this situation is," Dimon told his slightly alarmed guests as he mixed himself a martini. "You're going to read about it tomorrow in the papers."

As he promised, Saturday's papers prominently featured the dramatic news to which he had alluded. Leaning against the kitchen counter, Dimon opened the *Wall Street Journal* and read the headline of its lead story: "Lehman Races Clock; Crisis Spreads."

Dimon knew that Lehman Brothers might not make it through the

weekend. JP Morgan had examined its books earlier that week as a potential lender and had been unimpressed. He also had decided to request some extra collateral from the firm out of fear it might fall. In the next twenty-four hours, Dimon knew, Lehman would either be rescued or ruined. Knowing what he did, however, Dimon was concerned about more than just Lehman Brothers. He was aware that Merrill Lynch, another icon of Wall Street, was in trouble, too, and he had just asked his staff to make sure JP Morgan had enough collateral from that firm as well. And he was also acutely aware of new dangers developing at the global insurance giant American International Group (AIG) that so far had gone relatively unnoticed by the public—it was his firm’s client, and they were scrambling to raise additional capital to save it. By his estimation AIG had only about a week to find a solution, or it, too, could falter.

Of the handful of principals involved in the dialogue about the enveloping crisis—the government included—Dimon was in an especially unusual position. He had the closest thing to perfect, real-time information. That “deal flow” enabled him to identify the fraying threads in the fabric of the financial system, even in the safety nets that others assumed would save the day.

Dimon began contemplating a worst-case scenario, and at 7:30 a.m. he went into his home library and dialed into a conference call with two dozen members of his management team.

“You are about to experience the most unbelievable week in America ever, and we have to prepare for the absolutely worst case,” Dimon told his staff. “We have to protect the firm. This is about our survival.”

His staff listened intently, but no one was quite certain what Dimon was trying to say.

Like most people on Wall Street—including Richard S. Fuld Jr., Lehman’s CEO, who enjoyed one of the longest reigns of any of its leaders—many of those listening to the call assumed that the government would intervene and prevent its failure. Dimon hastened to disabuse them of the notion.

“That’s wishful thinking. There is no way, in my opinion, that Washington is going to bail out an investment bank. Nor should they,” he said decisively. “I want you all to know that this is a matter of life and death. I’m serious.”



Then he dropped his bombshell, one that he had been contemplating for the entire morning. It was his ultimate doomsday scenario.

“Here’s the drill,” he continued. “We need to prepare right now for Lehman Brothers filing.” Then he paused. “And for Merrill Lynch filing.” He paused again. “And for AIG filing.” Another pause. “And for Morgan Stanley filing.” And after a final, even longer pause he added: “And potentially for Goldman Sachs filing.”

There was a collective gasp on the phone.

As Dimon had presciently warned in his conference call, the following days would bring a near collapse of the financial system, forcing a government rescue effort with no precedent in modern history. In a period of less than eighteen months, Wall Street had gone from celebrating its most profitable age to finding itself on the brink of an epochal devastation. Trillions of dollars in wealth had vanished, and the financial landscape was entirely reconfigured. The calamity would definitively shatter some of the most cherished principles of capitalism. The idea that financial wizards had conjured up a new era of low-risk profits, and that American-style financial engineering was the global gold standard, was officially dead.

As the unraveling began, many on Wall Street confronted a market unlike any they had ever encountered—one gripped by a fear and disorder that no invisible hand could tame. They were forced to make the most critical decisions of their careers, perhaps of their lives, in the context of a confusing rush of rumors and policy shifts, all based on numbers that were little more than best guesses. Some made wise choices, some got lucky, and still others lived to regret their decisions. In many cases, it’s still too early to tell whether they made the right choices.

In 2007, at the peak of the economic bubble, the financial services sector had become a wealth-creation machine, ballooning to more than 40 percent of total corporate profits in the United States. Financial products—including a new array of securities so complex that even many CEOs and boards of directors didn’t understand them—were an ever greater driving force of the nation’s economy. The mortgage industry was an especially important component of this system, providing loans that served as the

raw material for Wall Street's elaborate creations, repackaging and then reselling them around the globe.

With all the profits that were being generated, Wall Street was minting a new generation of wealth not seen since the debt-fueled 1980s. Those who worked in the finance industry earned an astounding \$53 billion in total compensation in 2007. Goldman Sachs, ranked at the top of the five leading brokerages at the onset of the crisis, accounted for \$20 billion of that total, which worked out to more than \$661,000 per employee. The company's chief executive officer, Lloyd Blankfein, alone took home \$68 million.

Financial titans believed they were creating more than mere profits, however. They were confident that they had invented a new financial model that could be exported successfully around the globe. "The whole world is moving to the American model of free enterprise and capital markets," Sandy Weill, the architect of Citigroup, said in the summer of 2007. "Not having American financial institutions that really are at the fulcrum of how these countries are converting to a free-enterprise system would really be a shame."

But while they were busy evangelizing their financial values and producing these dizzying sums, the big brokerage firms had been bolstering their bets with enormous quantities of debt. Wall Street firms had debt to capital ratios of 32 to 1. When it worked, this strategy worked spectacularly well, validating the industry's complex models and generating record earnings. When it failed, however, the result was catastrophic.

The Wall Street juggernaut that emerged from the collapse of the dot-com bubble and the post-9/11 downturn was in large part the product of cheap money. The savings glut in Asia, combined with unusually low U.S. interest rates under former Federal Reserve chairman Alan Greenspan (which had been intended to stimulate growth following the 2001 recession), began to flood the world with money.

The crowning example of liquidity run amok was the subprime mortgage market. At the height of the housing bubble, banks were eager to make home loans to nearly anyone capable of signing on the dotted line. With no documentation a prospective buyer could claim a six-figure salary and walk out of a bank with a \$500,000 mortgage, topping it off a month later with a home equity line of credit. Naturally, home prices skyrocketed,

and in the hottest real estate markets ordinary people turned into speculators, flipping homes and tapping home equity lines to buy SUVs and power boats.

At the time, Wall Street believed fervently that its new financial products—mortgages that had been sliced and diced, or “securitized”—had diluted, if not removed, the risk. Instead of holding on to a loan on their own, the banks split it up into individual pieces and sold those pieces to investors, collecting enormous fees in the process. But whatever might be said about bankers’ behavior during the housing boom, it can’t be denied that these institutions “ate their own cooking”—in fact, they gorged on it, buying mountains of mortgage-backed assets from one another.

But it was the new ultra-interconnectedness among the nation’s financial institutions that posed the biggest risk of all. As a result of the banks owning various slices of these newfangled financial instruments, every firm was now dependent on the others—and many didn’t even know it. If one fell, it could become a series of falling dominoes.

There were, of course, Cassandras in both business and academia who warned that all this financial engineering would end badly. While Professors Nouriel Roubini and Robert J. Shiller have become this generation’s much-heralded doomsayers, even as others made prescient predictions as early as 1994 that went unheeded.

“The sudden failure or abrupt withdrawal from trading of any of these large U.S. dealers could cause liquidity problems in the markets and could also pose risks to others, including federally insured banks and the financial system as a whole,” Charles A. Bowsher, the comptroller general, told a congressional committee after being tasked with studying a developing market known as derivatives. “In some cases intervention has and could result in a financial bailout paid for or guaranteed by taxpayers.”

But when cracks did start to emerge in 2007, many argued even then that subprime loans posed little risk to anyone beyond a few mortgage firms. “The impact on the broader economy and the financial markets of the problems in the subprime markets seems likely to be contained,” Ben S. Bernanke, the chairman of the Federal Reserve, said in testimony before Congress’s Joint Economic Committee in March 2007.

By August 2007, however, the \$2 trillion subprime market had collapsed, unleashing a global contagion. Two Bear Stearns hedge funds that made

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