The Delaware Bay Company LLC

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THE PANIC OF '08 REVISITED

"It's the leverage, stupid!"

The two who voted yes with their fingers crossed.
Where were the grown-ups?

When you're one of eight children, you learn humility and not to think you're better than other people real fast. And as if my be-sainted parents hadn't gotten the point across, the Sacred Heart Fathers and the Christian Brothers of Ireland were not afraid to (quite literally) beat it into you. Later having grown up to become a successful Wall Street investment professional, I have nonetheless always had that lesson firmly anchored in the back of my mind. That is, until a few years ago when I adjusted my perspective a wee bit. I had just returned in frustration from one of the many regular portfolio manager luncheons held at a private club to which I belong in Rockefeller Center. After hearing yet another series of ridiculous and unrealistic economic projections from people who should know better, I phoned home. "Mom", I said, "remember how you taught us all to be humble and not to ever think that we were smarter than other people? Well, I can tell you this, mom: it's taken me a long time to figure it out, but I'm certainly not any dumber!"

I recently attended a similar luncheon and listened to a roundtable discussion of what each participant thought was the cause of what I refer to as "the Panic of '08". (Actually, the market turmoil began in July of 2007 and continued until March 9, 2009). Once again, I was seated with some of our industry's best-and-brightest, men and women who were all products of the Very Best Schools. They placed the blame on everything from Alan Greenspan's decision to keep interest rates too low for too long to sub-prime mortgages and "liars' loans" (i.e., mortgages taken out by people who lied about their income and assets), to the too-high trade deficit and the too-low savings rate. Also under discussion were various proposals floating around Congress about how to deal with firms deemed to be "too big to fail". I submit that the way to deal with the latter is to first understand the cause of the former – and with all due respect to my colleagues, they've got it all wrong.

The SEC lets the fox in the henhouse.

The real blame for the worst financial crisis since the Great Depression lies squarely with the SEC, which on April 28, 2004, acceded to pleas from the Big Five investment banks (Goldman Sachs, Morgan Stanley; Merrill Lynch; Lehman Brothers, and Bear Stearns) to relax net capital rules which applied to their broker-dealer units. Until then, SEC-regulated broker-dealers could borrow no more than $12 for each dollar of equity. (In other words, $1 would allow them to buy roughly $13 worth of assets; the other $12 would be borrowed money – hence the term 'leverage'). The Big Five convinced the SEC commissioners and staff that they had sophisticated computer models which could be used to more efficiently monitor and control risk. What the SEC apparently failed to seriously consider, however, was that their decision would result in an explosion in the amount of borrowed money ('leverage') the Big Five were shortly about to take on – along with an <u>exponential</u> explosion in the

amount of assets they would then buy and add to their balance sheets.

Memories, of course, are short. A generalized rule of investing is that once a particularly harsh and painful economic lesson has been learned, it takes until the next generation of investors and traders comes along (without the scar tissue) before the same mistake is repeated. But it had been a mere six years since a hedge fund using sophisticated computer models for trading various securities blew up, almost causing a worldwide financial crisis. Known as Long Term Capital Management (LTCM), the firm boasted two Nobel laureates as key advisors and principal investors. But, ominously, it was not regulated by the SEC and thus was able to employ leverage of 27:1 – great for "enhancing returns" on the way up, but catastrophic when the value of its assets declined.

So what did the Big Five do after the SEC gave them the green light? They promptly levered up 30 and 40 to 1 and used the borrowed money to multiply their assets like rabbits. Now one does not have to go to the Harvard Business School to do this simple math (actually, plain-vanilla arithmetic will do): *if you have $1 in equity and you borrow another $29 to purchase a total of $30 worth of <u>anything</u>, and if the value of whatever it is you are buying declines by just <u>three percent</u>, your $1 in equity is wiped out.* (And, by the way, you still owe the other $29). And that, my friends, is exactly what happened.

By the summer of 2007, the Big Five had collectively borrowed so much money that when it came to re-deploying it into earning assets, they had pretty well satiated the pool of normal, creditworthy borrowing demand. Having stuffed all of the CLOs, CDOs, SIV's, and other exotic investment vehicles (which their propeller heads had concocted) with pretty much the maximum amount of quality product that then existed, they were forced to reach further and further down the credit quality totem pole in order to 'put to work' the truly stupendous amounts of money they had collectively borrowed. Indeed, *it was essentially that money which fuelled the housing boom*. Before too long, you started to see advertisements on the shopping carts at your local supermarket with the smiling face of a (usually newly-minted) mortgage broker beckoning you to refinance your mortgage, or, in the alternative, take out one with no money down – and/or with no documentation of your income or assets necessary, and/or even offering mortgages which allowed you to add the interest to the loan balance! Heck, why blame people for taking money on advantageous terms? The real guilt lies with the people who were foolish and greedy enough to offer it.

The voice in the wilderness.

Now getting back to the SEC's decision, to its credit, these things are not done in a vacuum. The proposal went out for public comment and quite a few were received – most from people within the industry. But out of the entire United States of America, only <u>one</u> person dissented. Leonard D. Bole, described as a "risk management expert" from Valparaiso, Indiana (where I went to grade school in the 'heartland of America') presciently foresaw that in a market meltdown, all bets were off. As did actually happen during the LTCM crisis in 1998 – as well as during the stock market crash of 1987 – he predicted that the Big Five's computer models simply would not work. And, he pointed out, if the purpose of net capital is to provide a cushion of equity to protect the consumer, why lower it at all?

With fingers crossed.

While Mr. Bole never got a response, it appears that at least two of the SEC commissioners may have been troubled by the concerns which he raised. But that was not enough to make them vote against the proposed rule change.

Commissioner Harvey J. Goldschmid, a distinguished professor of law at Columbia University – who also had been a former general counsel of the SEC as well as special assistant to Arthur Levitt when he was then chairman – inquired as to the potential consequences of approving the rule change, but the staff assured him that it would only apply to the Big Five. The other hundreds of investment banks would continue to have limits on how much leverage they could employ. Which meant, Mr. Goldschmid then said (to nervous

laughter which can be clearly heard on the tape recording of the meeting), *"if anything goes wrong, it's going to be an awfully big mess"*.

Likewise, Commissioner Roel C. Campos, a Harvard law graduate and co-owner of El Dorado Communications, the Texas radio station chain, also voted yes, but then deadpanned that he was *"keeping my fingers crossed for the future"*. In the end, all five commissioners, including then-SEC chairman William H. Donaldson – himself the founder and former chairman of investment bank Donaldson, Lufkin & Jenrette – voted unanimously to approve the change.

With the shackles which had been in place for decades removed, the Big Five immediately went on a borrowing binge. By September of 2008, peak leverage ratios for investment banks approached 35:1, with Merrill Lynch and Bear Stearns having at one point exceeded 40:1. As for the investment banks to whom the new rule change did not apply? Well, it was actually pretty boring, because even though their leverage ratios are still capped by law at 12:1, they are nonetheless required to issue an early warning to the SEC when they begin approaching that limit and are actually forced to stop trading if they exceed it, so most keep their debt-to-net capital ratios comfortably lower. And the same pretty much went for the big commercial banks: they are primarily regulated by the Federal Reserve, not the SEC, and even Citigroup (the holding company, not the bank) never got higher than 19:1.

Where were the grown-ups?

Now what with the kind of high-octane leverage having being employed by the Big Five, you would think that some people would have been getting a bit nervous. Indeed, firms run internal stress tests all the time, in which they create a whole lot of different "what if" scenarios to see what impact they would have on their firms. Nonetheless, when questioned earlier this month in front of a Congressional committee especially appointed to investigate the causes of the financial meltdown, Jamie Dimon, the very highly respected chairman of JPMorgan, admitted that *in not a single stress test had anyone thought to plug in a decline in housing values*. Imagine! No one said something along the lines of, "gee let's see what happens if house prices drop by three percent." (In truth, someone may very well have made that suggestion but was probably hooted down – or, worse, fired). Talk about 'group think' in action!

And where were the members of the boards of directors of the Big Five? Were they not reading the financial statements which were presented to them at every board meeting? Did they not see how total debt and total assets were exploding while the line for total equity capital was increasing by only a fraction?

I have absolutely no sympathy for Stan O'Neal, Dick Fuld, John Mack and Jimmy Cayne, the heads, respectively, of Merrill Lynch, Lehman Brothers, Morgan Stanley and Bear Stearns. (How can you have sympathy for men who destroyed their firms, triggered the worst financial panic since the Great Depression – and still managed to walk away with hundreds of millions?) By their profligate devil-may-care addiction to using borrowed money, they brought the world's economy crashing down and caused the destruction of company after company – with all of the attendant pain and suffering incurred by millions and millions of people. And what do they have to say about it? Get a load of this: here's what the New York Times, in its January 17 edition, had to say, quoting John Mack (with whom I worked at Morgan Stanley in the early 1980's): "*the firm took on such risks because everyone else on Wall Street was doing it, too. 'Did I have too much leverage?' he says. 'Yes. But the whole industry did'."*

Excuse me? Anyone with a seven-year-old knows the universal and timeworn parental retort to that one: "*So . . . if everyone else was jumping off a cliff, you would, too?"*

Conclusion

There is a simple solution to both the too-big-to-fail and overleveraging issues. Put leverage caps back on and make sure they apply to more than just banks, investment banks, and broker dealers. Having it apply only to banks which have access to insured deposits or the Fed's Discount Window will

only incentivize what I *guarantee* you Goldman Sachs and Morgan Stanley are already quietly studying internally: how and when to give up their bank holding company status. (And, in the case of Goldman Sachs, probably go private as well – which would further eliminate transparency). If that happens, and if the big investment banks are allowed to borrow tons of money with which to make risky bets in order to enhance their returns (actually, the bets don't have to be risky at all – as the example of a three-percent decline in housing values I used earlier illustrates), they clearly will not be able to resist the temptation to do so.

Many of us have told our clients that the good thing about the Panic of '08 is that it is something that happens only once every 75 or 100 years and that as a result, none of us will be around for the next one. I'm not so sure. Unless the ability of investment banks, hedge funds, and other "non-bank banks" to borrow ever-increasing amounts of money is curtailed, they will remain risks to the world's financial system. Remember, there were only six years between the mini-panic of 1998 and when the SEC took the borrowing caps off the Big Five in 2004. Less than five years later, the "Big Five" were no more. Two went bankrupt and were liquidated; one was sold at a fire-sale price, and the other two saved themselves by becoming commercial banks.

It really is "*the leverage*, stupid".

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