OP-ED CONTRIBUTORS

The End of the Financial World as We Know It

By MICHAEL LEWIS and DAVID EINHORN
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AMERICANS enter the New Year in a strange new role: financial lunatics. We've been viewed by the wider world with mistrust and suspicion on other matters, but on the subject of money even our harshest critics have been inclined to believe that we knew what we were doing. They watched our investment bankers and emulated them: for a long time now half the planet's college graduates seemed to want nothing more out of life than a job on Wall Street.

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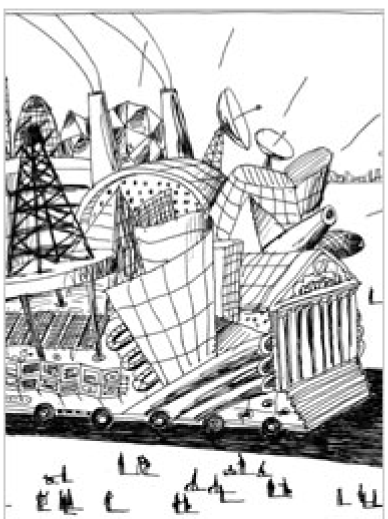

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This is one reason the collapse of our financial system has inspired not merely a national but a global crisis of confidence. *Good God*, the world seems to be saying, *if they don't know what they are doing with money, who does*?

Incredibly, intelligent people the world over remain willing to lend us money and even listen to our advice; they appear not to have realized the full extent of our madness. We have at least a brief chance to cure ourselves. But first we need to ask: of what?

To that end consider the strange story of Harry Markopolos. Mr. Markopolos is the former investment officer with Rampart Investment Management in Boston who, for nine years, tried to explain to the Securities and Exchange Commission that Bernard L. Madoff couldn't be anything other than a fraud. Mr. Madoff's investment performance, given his stated strategy, was not merely improbable but mathematically impossible. And so, Mr. Markopolos reasoned, Bernard Madoff must be doing something other than what he said he was doing.

In his devastatingly persuasive 17-page letter to the S.E.C., Mr. Markopolos saw two possible scenarios. In the "Unlikely" scenario: Mr. Madoff, who acted as a broker as well as an investor, was "front-running" his brokerage customers. A customer might submit an order to Madoff Securities to buy shares in I.B.M. at a certain price, for example, and Madoff Securities instantly would buy I.B.M. shares for its own portfolio ahead of the customer order. If I.B.M.'s shares rose, Mr. Madoff kept them; if they fell he fobbed them off onto the poor customer.

In the "Highly Likely" scenario, wrote Mr. Markopolos, "Madoff Securities is the world's largest Ponzi Scheme." Which, as we now know, it was.

Harry Markopolos sent his report to the S.E.C. on Nov. 7, 2005 — more than three years before Mr. Madoff was finally exposed — but he had been trying to explain the fraud to them since 1999. He had no direct financial interest in exposing Mr. Madoff — he wasn't an unhappy investor or a disgruntled employee. There was no way to short shares in Madoff Securities, and so Mr. Markopolos could not have made money directly from Mr. Madoff's failure. To judge from his letter, Harry Markopolos anticipated mainly downsides for himself: he declined to put his name on it for fear of what might happen to him and his family if anyone found out he had written it. And yet the S.E.C.'s cursory investigation of Mr. Madoff pronounced him free of fraud.

What's interesting about the Madoff scandal, in retrospect, is how little interest *anyone* inside the financial system had in exposing it. It wasn't just Harry Markopolos who smelled a rat. As Mr. Markopolos explained in his letter, Goldman Sachs was refusing to do business with Mr. Madoff; many others doubted Mr. Madoff's profits or assumed he was front-running his customers and steered clear of him. Between the lines, Mr. Markopolos hinted that even some of Mr. Madoff's investors may have suspected that they were the beneficiaries of a scam. After all, it wasn't all that hard to see that the profits were too good to be true. Some of Mr. Madoff's investors may have reasoned that the worst that could happen to them, if the authorities put a stop to the front-running, was that a good thing would come to an end.

The Madoff scandal echoes a deeper absence inside our financial system, which has been undermined not merely by bad behavior but by the lack of checks and balances to discourage it. "Greed" doesn't cut it as a satisfying explanation for the current financial crisis. Greed was necessary but insufficient; in any case, we are as likely to eliminate greed from our national character as we are lust and envy. The fixable problem isn't the greed of the few but the misaligned interests of the many.

A lot has been said and written, for instance, about the corrupting effects on Wall Street of gigantic bonuses. What happened inside the major Wall Street firms, though, was more deeply unsettling than greedy people lusting for big checks: leaders of public corporations, especially financial corporations, are as good as required to lead for the short term.

Richard Fuld, the former chief executive of Lehman Brothers, E. Stanley O'Neal, the former chief executive of Merrill Lynch, and

Charles O. Prince III, Citigroup's chief executive, may have paid themselves humongous sums of money at the end of each year, as a result of the bond market bonanza. But if any one of them had set himself up as a whistleblower — had stood up and said "this business is irresponsible and we are not going to participate in it" — he would probably have been fired. Not immediately, perhaps. But a few quarters of earnings that lagged behind those of every other Wall Street firm would invite outrage from subordinates, who would flee for other, less responsible firms, and from shareholders, who would call for his resignation. Eventually he'd be replaced by someone willing to make money from the credit bubble.

OUR financial catastrophe, like Bernard Madoff's pyramid scheme, required all sorts of important, plugged-in people to sacrifice our collective long-term interests for short-term gain. The pressure to do this in today's financial markets is immense. Obviously the greater the market pressure to excel in the short term, the greater the need for pressure from outside the market to consider the longer term. But that's the problem: there is no longer any serious pressure from outside the market. The tyranny of the short term has extended itself with frightening ease into the entities that were meant to, one way or another, discipline Wall Street, and force it to consider its enlightened self-interest.

The credit-rating agencies, for instance.

Everyone now knows that Moody's and Standard & Poor's botched their analyses of bonds backed by home mortgages. But their most costly mistake — one that deserves a lot more attention than it has received — lies in their area of putative expertise: measuring corporate risk.

Over the last 20 years American financial institutions have taken on more and more risk, with the blessing of regulators, with hardly a word from the rating agencies, which, incidentally, are paid by the issuers of the bonds they rate. Seldom if ever did Moody's or Standard

& Poor's say, "If you put one more risky asset on your balance sheet, you will face a serious downgrade."

The American International Group, Fannie Mae, Freddie Mac, General Electric and the municipal bond guarantors Ambac Financial and MBIA all had triple-A ratings. (G.E. still does!) Large investment banks like Lehman and Merrill Lynch all had solid investment grade ratings. It's almost as if the higher the rating of a financial institution, the more likely it was to contribute to financial catastrophe. But of course all these big financial companies fueled the creation of the credit products that in turn fueled the revenues of Moody's and Standard & Poor's.

These oligopolies, which are actually sanctioned by the S.E.C., didn't merely do their jobs badly. They didn't simply miss a few calls here and there. In pursuit of their own short-term earnings, they did exactly the opposite of what they were meant to do: rather than expose financial risk they systematically disguised it.

This is a subject that might be profitably explored in Washington. There are many questions an enterprising United States senator might want to ask the credit-rating agencies. Here is one: Why did you allow MBIA to keep its triple-A rating for so long? In 1990 MBIA was in the relatively simple business of insuring municipal bonds. It had $931 million in equity and only $200 million of debt — and a plausible triple-A rating.

By 2006 MBIA had plunged into the much riskier business of guaranteeing collateralized debt obligations, or C.D.O.'s. But by then it had $7.2 billion in equity against an astounding $26.2 billion in debt. That is, even as it insured ever-greater risks in its business, it also took greater risks on its balance sheet.

Yet the rating agencies didn't so much as blink. On Wall Street the problem was hardly a secret: many people understood that MBIA didn't deserve to be rated triple-A. As far back as 2002, a hedge fund called Gotham Partners published a persuasive report, widely circulated, entitled: “Is MBIA Triple A?” (The answer was obviously no.)

At the same time, almost everyone believed that the rating agencies would never downgrade MBIA, because doing so was not in their short-term financial interest. A downgrade of MBIA would force the rating agencies to go through the costly and cumbersome process of re-rating tens of thousands of credits that bore triple-A ratings simply by virtue of MBIA’s guarantee. It would stick a wrench in the machine that enriched them. (In June, finally, the rating agencies downgraded MBIA, after MBIA’s failure became such an open secret that nobody any longer cared about its formal credit rating.)

The S.E.C. now promises modest new measures to contain the damage that the rating agencies can do — measures that fail to address the central problem: that the raters are paid by the issuers.

But this should come as no surprise, for the S.E.C. itself is plagued by similarly wacky incentives. Indeed, one of the great social benefits of the Madoff scandal may be to finally reveal the S.E.C. for what it has become.

Created to protect investors from financial predators, the commission has somehow evolved into a mechanism for protecting financial predators with political clout from investors. (The task it has performed most diligently during this crisis has been to question, intimidate and impose rules on short-sellers — the only market players who have a financial incentive to expose fraud and abuse.)

The instinct to avoid short-term political heat is part of the problem; anything the S.E.C. does to roil the markets, or reduce the share price of any given company, also roils the careers of the people who run the S.E.C. Thus it seldom penalizes serious corporate and management malfeasance — out of some misguided notion that to do so would cause stock prices to fall, shareholders to suffer and confidence to be undermined. Preserving confidence, even when that confidence is false, has been near the top of the S.E.C.’s agenda.

IT'S not hard to see why the S.E.C. behaves as it does. If you work for the enforcement division of the S.E.C. you probably know in the back of your mind, and in the front too, that if you maintain good relations with Wall Street you might soon be paid huge sums of money to be employed by it.

The commission's most recent director of enforcement is the general counsel at JPMorgan Chase; the enforcement chief before him became general counsel at Deutsche Bank; and one of his predecessors became a managing director for Credit Suisse before moving on to Morgan Stanley. A casual observer could be forgiven for thinking that the whole point of landing the job as the S.E.C.'s director of enforcement is to position oneself for the better paying one on Wall Street.

At the back of the version of Harry Markopolos's brave paper currently making the rounds is a copy of an e-mail message, dated April 2, 2008, from Mr. Markopolos to Jonathan S. Sokobin. Mr. Sokobin was then the new head of the commission's office of risk assessment, a job that had been vacant for more than a year after its previous occupant had left to — you guessed it — take a higher-paying job on Wall Street.

At any rate, Mr. Markopolos clearly hoped that a new face might mean a new ear — one that might be receptive to the truth. He phoned Mr. Sokobin and then sent him his paper. "Attached is a submission I've made to the S.E.C. three times in Boston," he wrote. "Each time Boston sent this to New York. Meagan Cheung, branch chief, in New York actually investigated this but with no result that I am aware of. In my conversations with her, I did not believe that she had the derivatives or mathematical background to understand the violations."

How does this happen? How can the person in charge of assessing Wall Street firms not have the tools to understand them? Is the S.E.C. that inept? Perhaps, but the problem inside the commission is far worse — because inept people can be replaced. The problem is systemic. The new director of risk assessment was no more likely to grasp the risk of Bernard Madoff than the old director of risk assessment because the new guy's thoughts and beliefs were guided by the same incentives: the need to curry favor with the politically influential and the desire to keep sweet the Wall Street elite.

And here's the most incredible thing of all: 18 months into the most spectacular man-made financial calamity in modern experience, nothing has been done to change that, or any of the other bad incentives that led us here in the first place.

SAY what you will about our government's approach to the financial crisis, you cannot accuse it of wasting its energy being consistent or trying to win over the masses. In the past year there have been at least seven different bailouts, and six different strategies. And none of them seem to have pleased anyone except a handful of financiers.

When Bear Stearns failed, the government induced JPMorgan Chase to buy it by offering a knockdown price and guaranteeing Bear Stearns's shakiest assets. Bear Stearns bondholders were made whole and its stockholders lost most of their money.

Then came the collapse of the government-sponsored entities, Fannie Mae and Freddie Mac, both promptly nationalized. Management was replaced, shareholders badly diluted, creditors left intact but with some uncertainty. Next came Lehman Brothers, which was, of course, allowed to go bankrupt. At first, the Treasury and the Federal Reserve claimed they had allowed Lehman to fail in order to signal that recklessly managed Wall Street firms did not all come with government guarantees; but then, when chaos ensued, and people started saying that letting Lehman fail was a dumb thing to have done, they changed their story and claimed they lacked the legal authority to rescue the firm.

But then a few days later A.I.G. failed, or tried to, yet was given the gift of life with enormous government loans. Washington Mutual and

Wachovia promptly followed: the first was unceremoniously seized by the Treasury, wiping out both its creditors and shareholders; the second was batted around for a bit. Initially, the Treasury tried to persuade Citigroup to buy it — again at a knockdown price and with a guarantee of the bad assets. (The Bear Stearns model.) Eventually, Wachovia went to Wells Fargo, after the Internal Revenue Service jumped in and sweetened the pot with a tax subsidy.

In the middle of all this, Treasury Secretary Henry M. Paulson Jr. persuaded Congress that he needed $700 billion to buy distressed assets from banks — telling the senators and representatives that if they didn't give him the money the stock market would collapse. Once handed the money, he abandoned his promised strategy, and instead of buying assets at market prices, began to overpay for preferred stocks in the banks themselves. Which is to say that he essentially began giving away billions of dollars to Citigroup, Morgan Stanley, Goldman Sachs and a few others unnaturally selected for survival. The stock market fell anyway.

It's hard to know what Mr. Paulson was thinking as he never really had to explain himself, at least not in public. But the general idea appears to be that if you give the banks capital they will in turn use it to make loans in order to stimulate the economy. Never mind that if you want banks to make smart, prudent loans, you probably shouldn't give money to bankers who sunk themselves by making a lot of stupid, imprudent ones. If you want banks to re-lend the money, you need to provide them not with preferred stock, which is essentially a loan, but with tangible common equity — so that they might write off their losses, resolve their troubled assets and then begin to make new loans, something they won't be able to do until they're confident in their own balance sheets. But as it happened, the banks took the taxpayer money and just sat on it.

Continued at "How to Repair a Broken Financial World."

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How to Repair a Broken Financial World

E-MAILBy MICHAEL LEWIS and DAVID EINHORN
Published: January 3, 2009

Continued from "The End of the Financial World As We Know It"

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Mr. Paulson must have had some reason for doing what he did. No doubt he still believes that without all this frantic activity we'd be far worse off than we are now. All we know for sure, however, is that the Treasury's heroic deal-making has had little effect on what it claims is the problem at hand: the collapse of confidence in the companies atop our financial system.

Weeks after receiving its first $25 billion taxpayer investment, Citigroup returned to the Treasury to confess that — lo! — the markets still didn't trust Citigroup to survive. In response, on Nov. 24, the Treasury handed Citigroup another $20 billion from the Troubled Assets Relief Program, and then simply guaranteed $306 billion of Citigroup's assets. The Treasury didn't ask for its fair share of the action, or management changes, or for that matter anything much at all beyond a teaspoon of warrants and a sliver of preferred stock. The $306 billion guarantee was an undisguised gift. The Treasury didn't even bother to explain what the crisis was, just that the action was taken in response to Citigroup's "declining stock price."

Three hundred billion dollars is still a lot of money. It's almost 2 percent of gross domestic product, and about what we spend annually on the departments of Agriculture, Education, Energy, Homeland Security, Housing and Urban Development and Transportation combined. Had Mr. Paulson executed his initial plan, and bought Citigroup's pile of troubled assets at market prices, there would have been a limit to our exposure, as the money would have counted against the $700 billion Mr. Paulson had been given to dispense. Instead, he in effect granted himself the power to dispense unlimited sums of money without Congressional oversight. Now we don't even know the nature of the assets that the Treasury is standing behind. Under TARP, these would have been disclosed.

THERE are other things the Treasury might do when a major financial firm assumed to be "too big to fail" comes knocking, asking for free money. Here's one: Let it fail.

Not as chaotically as Lehman Brothers was allowed to fail. If a failing firm is deemed "too big" for that honor, then it should be explicitly nationalized, both to limit its effect on other firms and to protect the guts of the system. Its shareholders should be wiped out, and its management replaced. Its valuable parts should be sold off as functioning businesses to the highest bidders — perhaps to some bank that was not swept up in the credit bubble. The rest should be liquidated, in calm markets. Do this and, for everyone except the firms that invented the mess, the pain will likely subside.

This is more plausible than it may sound. Sweden, of all places, did it successfully in 1992. And remember, the Federal Reserve and the Treasury have already accepted, on behalf of the taxpayer, just about all of the downside risk of owning the bigger financial firms. The Treasury and the Federal Reserve would both no doubt argue that if you don't prop up these banks you risk an enormous credit contraction — if they aren’t in business who will be left to lend money? But something like the reverse seems more true: propping up failed banks and extending them huge amounts of credit has made business more difficult for the people and companies that had nothing to do with creating the mess. Perfectly solvent companies are being squeezed out of business by their creditors precisely because they are not in the Treasury’s fold. With so much lending effectively federally guaranteed, lenders are fleeing anything that is not.

Rather than tackle the source of the problem, the people running the bailout desperately want to reinflate the credit bubble, prop up the stock market and head off a recession. Their efforts are clearly failing: 2008 was a historically bad year for the stock market, and we’ll be in recession for some time to come. Our leaders have framed the problem as a “crisis of confidence” but what they actually seem to mean is “please pay no attention to the problems we are failing to address.”

In its latest push to compel confidence, for instance, the authorities are placing enormous pressure on the Financial Accounting Standards Board to suspend “mark-to-market” accounting. Basically, this means that the banks will not have to account for the actual value of the assets on their books but can claim instead that they are worth whatever they paid for them.

This will have the double effect of reducing transparency and increasing self-delusion (gorge yourself for months, but refuse to step on a scale, and maybe no one will realize you gained weight). And it will fool no one. When you shout at people “be confident,” you shouldn’t expect them to be anything but terrified.

If we are going to spend trillions of dollars of taxpayer money, it makes more sense to focus less on the failed institutions at the top of the financial system and more on the individuals at the bottom. Instead of buying dodgy assets and guaranteeing deals that should never have been made in the first place, we should use our money to

A) repair the social safety net, now badly rent in ways that cause perfectly rational people to be terrified; and B) transform the bailout of the banks into a rescue of homeowners.

We should begin by breaking the cycle of deteriorating housing values and resulting foreclosures. Many homeowners realize that it doesn't make sense to make payments on a mortgage that exceeds the value of their house. As many as 20 million families face the decision of whether to make the payments or turn in the keys. Congress seems to have understood this problem, which is why last year it created a program under the Federal Housing Authority to issue homeowners new government loans based on the current appraised value of their homes.

And yet the program, called Hope Now, seems to have become one more excellent example of the unhappy political influence of Wall Street. As it now stands, banks must initiate any new loan; and they are loath to do so because it requires them to recognize an immediate loss. They prefer to "work with borrowers" through loan modifications and payment plans that present fewer accounting and earnings problems but fail to resolve and, thereby, prolong the underlying issues. It appears that the banking lobby also somehow inserted into the law the dubious requirement that troubled homeowners repay all home equity loans before qualifying. The result: very few loans will be issued through this program.

THIS could be fixed. Congress might grant qualifying homeowners the ability to get new government loans based on the current appraised values without requiring their bank's consent. When a corporation gets into trouble, its lenders often accept a partial payment in return for some share in any future recovery. Similarly, homeowners should be permitted to satisfy current first mortgages with a combination of the proceeds of the new government loan and a share in any future recovery from the future sale or refinancing of their homes. Lenders who issued second mortgages should be forced to release their claims on property. The important point is that homeowners, not lenders, be granted the right to obtain new government loans. To work, the program needs to be universal and should not require homeowners to file for bankruptcy.

There are also a handful of other perfectly obvious changes in the financial system to be made, to prevent some version of what has happened from happening all over again. A short list:

Stop making big regulatory decisions with long-term consequences based on their short-term effect on stock prices. Stock prices go up and down: let them. An absurd number of the official crises have been negotiated and resolved over weekends so that they may be presented as a fait accompli "before the Asian markets open." The hasty crisis-to-crisis policy decision-making lacks coherence for the obvious reason that it is more or less driven by a desire to please the stock market. The Treasury, the Federal Reserve and the S.E.C. all seem to view propping up stock prices as a critical part of their mission — indeed, the Federal Reserve sometimes seems more concerned than the average Wall Street trader with the market's day-to-day movements. If the policies are sound, the stock market will eventually learn to take care of itself.

End the official status of the rating agencies. Given their performance it's hard to believe credit rating agencies are still around. There's no question that the world is worse off for the existence of companies like Moody's and Standard & Poor's. There should be a rule against issuers paying for ratings. Either investors should pay for them privately or, if public ratings are deemed essential, they should be publicly provided.

Regulate credit-default swaps. There are now tens of trillions of dollars in these contracts between big financial firms. An awful lot of the bad stuff that has happened to our financial system has happened because it was never explained in plain, simple language. Financial innovators were able to create new products and markets without anyone thinking too much about their broader financial consequences

— and without regulators knowing very much about them at all. It doesn't matter how transparent financial markets are if no one can understand what's inside them. Until very recently, companies haven't had to provide even cursory disclosure of credit-default swaps in their financial statements.

Credit-default swaps may not be Exhibit No. 1 in the case against financial complexity, but they are useful evidence. Whatever credit defaults are in theory, in practice they have become mainly side bets on whether some company, or some subprime mortgage-backed bond, some municipality, or even the United States government will go bust. In the extreme case, subprime mortgage bonds were created so that smart investors, using credit-default swaps, could bet against them. Call it insurance if you like, but it's not the insurance most people know. It's more like buying fire insurance on your neighbor's house, possibly for many times the value of that house — from a company that probably doesn't have any real ability to pay you if someone sets fire to the whole neighborhood. The most critical role for regulation is to make sure that the sellers of risk have the capital to support their bets.

Impose new capital requirements on banks. The new international standard now being adopted by American banks is known in the trade as Basel II. Basel II is premised on the belief that banks do a better job than regulators of measuring their own risks — because the banks have the greater interest in not failing. Back in 2004, the S.E.C. put in place its own version of this standard for investment banks. We know how that turned out. A better idea would be to require banks to hold less capital in bad times and more capital in good times. Now that we have seen how too-big-to-fail financial institutions behave, it is clear that relieving them of stringent requirements is not the way to go.

Another good solution to the too-big-to-fail problem is to break up any institution that becomes too big to fail.

Close the revolving door between the S.E.C. and Wall Street. At every turn we keep coming back to an enormous barrier to reform: Wall Street's political influence. Its influence over the S.E.C. is further compromised by its ability to enrich the people who work for it. Realistically, there is only so much that can be done to fix the problem, but one measure is obvious: forbid regulators, for some meaningful amount of time after they have left the S.E.C., from accepting high-paying jobs with Wall Street firms.

But keep the door open the other way. If the S.E.C. is to restore its credibility as an investor protection agency, it should have some experienced, respected investors (which is not the same thing as investment bankers) as commissioners. President-elect Barack Obama should nominate at least one with a notable career investing capital, and another with experience uncovering corporate misconduct. As it happens, the most critical job, chief of enforcement, now has a perfect candidate, a civic-minded former investor with firsthand experience of the S.E.C.'s ineptitude: Harry Markopolos.

The funny thing is, there's nothing all that radical about most of these changes. A disinterested person would probably wonder why many of them had not been made long ago. A committee of people whose financial interests are somehow bound up with Wall Street is a different matter.

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