Too Big to Fail: The Inside Story of How Wall Street and Washington Fought to Save the Financial System – and Themselves

ANDREW ROSS SORKIN
Penguin Group, New York, USA, pp. 600

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* Received: October 29, 2010
Accepted: November 2, 2010

FINANCIAL THEORY AND PRACTICE
35 (1) 129-133 (2011)

Too Big to Fail, by Andrew Ross Sorkin, is probably the best and most detailed account of the collapse of the financial system. Unlike many other books on this topic, Sorkin's does not concentrate on economic theory. This is not a book about economic theory. Instead, this book provides an insight into the main characters of the financial crises – above all Wall Street CEOs, Henry Paulson, the Treasury Secretary, and central bankers like Timothy Geithner, Alan Greenspan and Ben Bernanke. Sorkin does not try to explain complicated theoretical models, but what role "real" people had in the events building up to the crisis and in attempts to minimize the negative effects it had. In that respect, this book probably represents the best *economic history* of the recent financial crisis. Sorkin concentrates on the failure of Lehman Brothers, even though he describes the fate of other Wall Street banks.

Yet, even though this book does not explain the mainstream economic theory of financial markets, it clearly shows how economic theory has become detached from reality. In fact, this book is best read after getting some sense of the dominant theory of financial markets – efficient markets theory.

Efficient markets theory claims self-regulating markets are a way of organizing economic activities, including financial markets, superior to any form of government regulation. This claim is grounded in a number of assumptions. For one, investors are thought to be rational and thus better judges of their own interest than the government. Yet, this book provides more than enough instances to show that decision-making is a far more complex process, even among the best Wall Street bankers. In many aspects, their decisions were motivated not by reason but by emotions. For instance, a very close friendship between Richard Fuld, Lehman Brothers' CEO, and his chief operations officer, Joe Gregory, prevented him from realizing that Gregory's unorthodox employment policies were damaging the company. Gregory believed in Jungian psychological principles to identify people as having one of sixteen different personality types and he used these principles for staff decisions. As a result, people with very limited training in the field were recruited for the highest management jobs. Ultimately, Fuld did fire his friend, but only after serious pressure from other board members and after much of the damage was done.

Friendship was not the only affection that had the upper hand over Smithian purely rational self-interest. Devotion to country, i.e. patriotism, also influences decision making. For instance, after government took over mortgage lenders Fannie Mae and Freddie Mac, Henry Paulson called John Mack, CEO of Morgan Stanley, to be the government's advisor. The problem was that if Morgan Stanley did take the job, they would be forbidden from doing business with mortgage giants for the next six months, thus losing tens of millions of dollars. Yet, John Mack decided to take the job for it was a patriotic thing to do. The interest of his country came before interest of his company. Milton Friedman would not be very happy about that.

Some market players also clearly suffered from disaster myopia. For instance, many Wall Street bankers believed government would ultimately come to their rescue. Jamie Dimon of JP Morgan was one of rare top-notch bankers arguing government should not bail out an investment bank. When Lehman was crumbling, Treasury Secretary Henry Paulson organized a meeting of all "bosses" in an effort to save Lehman. The idea was to get other bankers to save Lehman instead of the state. Yet, one big boss was missing in this meeting and that was Richard Fuld, CEO of Lehman Brothers. When confronted by other bankers, Paulson explained why only lower Lehman staff was present. Paulson believed Fuld was in no condition to make any decision because he was in denial. And he really was. Feelings towards a company he had devoted his life to prevented Fuld from seeing reality clearly. And the reality was that if someone did not rescue Lehman, the days of one of the Wall Street giants were numbered.

Another essential component the self-regulating markets theory is that peer supervision will outperform government supervision. Yet, this crisis clearly showed inadequacies in peer supervision. For instance, with Lehman gasping its last breath, the pressure turned to AIG, an insurance giant with sizeable exposure to subprime mortgage-based securities. When other Wall Street players were allowed to look into Lehman and AIG books in order to save them from bankruptcy, they were astonished at the risks these companies were taking. Competition did not lead to prudent behavior, as predicted by the efficient market theory, but to excessive risk taking.

Some people believed that the problem of risk had been eliminated by "superior" statistical models and new financial products that enabled companies to diversify and minimize risks. Instead, it was precisely some of these new financial products that enhanced the crisis – namely short selling. In essence, short selling is betting that share prices will go down. Particularly damaging was naked short selling, which enables traders to bet on share prices going down without actually owning these shares. A number of Wall Street banks were putting intense pressure on the government to act on short sellers. As Gary Lynch of Morgan Stanley said: "I am in favor of free markets – and I am in favor of free streets too, but when you have people walking down the street with bats, maybe it's time for curfew". Eventually, US Treasury did get New York state attorney to go after short sellers. Financial innovations promoters, which were championed just years ago were now being hunted down like criminals.

Reality was also not very kind to efficient market theory's claim that the market gets prices right because it bases them in fundamentals. In fact, gossip can be even more important than reality. With the financial crisis well under way the rumor was Morgan Stanley had a very high exposure to AIG, increasingly troubled insurance giant, with around 200 billion dollars at stake. The rumor was false but it still sent Morgan Stanley's shares tumbling over 40 per cent in a single day. The

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reason why gossip can be as important as reality is the herd effect. People do not always stop and think for themselves. Instead, they just follow others, especially those who they think know better. So, it's enough for George Soros or Warren Buffett to "take the bait" and other players will follow suit.

But above all, the idea of self-regulating markets looks appealing during good times. But when things go bad, government intervention regains its popularity, and not without reason. As the new Fed Chairman, Ben Bernanke, told Henry Paulson in order to persuade him to intervene in the financial markets: "there are no atheists in foxholes and no ideologues in financial crisis". Put simply, Bernanke was saying that the government should forget about free markets for a while. And the government did just that. Even in the wake of the Bear Stearns crisis, it was the US Treasury that organized a takeover of Bear Stearns by JP Morgan for 2 dollars per share, though it was kept a secret. The price was set very low in order to punish the shareholders of the failed company – in this case Bear Stearns. And when JP Morgan increased its price to 10 dollars per share Henry Paulson was furious. Even when the government decided not to bail out Lehman Brothers, US Treasury organized a meeting of the "families" – all top Wall Street bankers were gathered in order to find a solution for Lehman. When no solution was found, the government ordered Lehman, a private company, to file for bankruptcy, possibly the first time in the US history! And the list does not stop here. The government was engaged in a hostile takeover of two mortgage giants – Fannie Mae and Freddie Mac. In fact, their CEOs were just informed that they are being taken over by the government. Additionally, after letting Lehman go bust, which was celebrated by some as "Free Market Day", the government quickly stepped in to save AIG. It is clear that when things go wrong, belief in self-correcting abilities of markets quickly wanes.

But, if this book is not very kind to the idea of self-regulating markets, it certainly rejects any conspiracy theories. For instance, Henry Paulson was accused of saving his Wall Street buddies (he was the CEO of Goldman Sachs before taking over as the US Treasury Secretary) with taxpayers' money and then letting them go with huge bonuses for bringing their banks to the brink of destruction. Sorkin argues that Paulson let Wall Street bankers keep their "golden parachutes" because it would take months to renegotiate terms of their contracts and the situation was so critical that the government needed to step in immediately to prevent the whole financial system from turning into ashes. Sorkin does not approve of some of Paulson's decisions, but Paulson is portrayed as a true professional. Paulson was also accused of bailing out AIG just days after letting Lehman go bankrupt to save Goldman Sachs, his old firm. It is true that Goldman was very exposed to AIG, but by the time the AIG rescue package came in, Goldman was already insured against the risk of AIG sharing Lehman's destiny. Paulson even signed a contract not to engage directly with his former employer, on which Paulson himself insisted, only to abolish it when it became obvious that it interfered with his ability to pre-

vent a full-blown meltdown of the entire financial sector. Plus, the AIG rescue was orchestrated primarily by Tim Geithner, head of the Fed's New York division, and not by Henry Paulson.

In conclusion, this book is a prime example of the economic and "human" history of recent financial crisis. Its focus is on events and human actors and not theoretical and statistical models. Yet, even though this book is not about economic theory, it clearly shows the discrepancy between how neoclassical economic theory views human nature and the economy and the reality. Markets work sometimes, but other times they fail to perform. People are not computers who just maximize their (material) well being. Individuals are also devoted to their friends, their country and can choose their well being over their own and their company's.

Even if this book is not about economic theory, Sorkin's conclusions certainly have some implications for it. Sorkin believes in the merits of free markets but he also believes in their limitations. Markets simply cannot recover from huge shocks by themselves, or at least not without huge costs. Henry Paulson's main error was precisely his belief in the self-correcting ability of the markets. Paulson did not cause the financial crisis; its origins have much deeper roots. But it was his handling of the crisis that was bad. His decision to let Lehman fail proved to be disastrous. What Paulson wanted was to reassure the markets that government would not bail out bad companies and to restore confidence by ensuring market players the government was still committed to the idea of free markets. Instead, he created chaos. On the other hand, Sorkin praises Alistair Darling, British finance minister, who when confronted with the looming financial crisis took decisive state action to prevent the whole system from collapsing and never had any illusions that markets could fix it themselves. The book does end on a worrying note, though. Even though many recipients of taxpayers' money have repaid their loans, one of the causes of the crisis has survived, and that is the Wall Street ego. Sorkin believes that what we need is a bit more humility on the financial markets. Well, good luck with that.