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OTHER VOICES

A Memo Found in the Street

By BARRY L. RITHOLTZ

Uncle Sam the enabler.

To: *Washington, D.C.*
From: *Wall Street*
Re: *Credit Crisis*

Dear D.C.,

WOW, WE'VE MADE QUITE A MESS OF THINGS here on Wall Street: Fannie and Freddie in conservatorship, investment banks in the tank, AIG nationalized. Thanks for sending us your new trillion-dollar bailout.

We on Wall Street feel somewhat compelled to take at least some responsibility. We used excessive leverage, failed to maintain adequate capital, engaged in reckless speculation, created new complex derivatives. We focused on short-term profits at the expense of sustainability. We not only undermined our own firms, we destabilized the financial sector and roiled the global economy, to boot. And we got huge bonuses.

But here's a news flash for you, D.C.: We could not have done it without you. We may be drunks, but you were our enablers: Your legislative, executive, and administrative decisions made possible all that we did. Our recklessness would not have reached its soaring heights but for your governmental incompetence.

THIS MEMO PROVIDES A BRIEF HISTORY OF your actions that helped create this crisis.

1997: Federal Reserve Chairman Alan Greenspan's famous "irrational exuberance" speech in 1996 was somehow ignored by, um, Fed Chairman Greenspan. The Fed missed the opportunity to change margin requirements. Had the Fed acted, the bubble would not have inflated as much, and the subsequent crash would not have been as severe.

1998: Long Term Capital Management was undercapitalized, used enormous amounts of leverage to purchase all manner of thinly traded, hard-to-value paper. It failed, and under the authority of the Federal Reserve a "private-sector" rescue plan was cobbled together. Had these bankers suffered big losses from LTCM, they might have thought twice before jumping into the exact same business model of undercapitalized, overleveraged, thinly traded, hard-to-value paper. Instead, they reaffirmed Benjamin Disraeli's famous aphorism: "What we learn from history is that we do not learn from history."

1999: The Financial Services Modernization Act repealed Glass-Steagall, a law that had separated the commercial-banking industry from Wall Street, and the two industries, plus insurance, came together again. Banks became bigger, clumsier, and hard to manage. Apparently, risk-management became all but impossible, even as banks had greater access to larger pools of capital.

2000: The Commodities Futures Modernization Act defined financial commodities such as "interest rates, currency prices, and stock indexes" as "excluded commodities." They could trade off the futures exchanges, with minimal oversight by the Commodity Futures Trading Commission. Neither the Securities and Exchange Commission, nor the Federal Reserve, nor any state insurance regulators had the ability to supervise or regulate the writing of credit-default swaps by hedge funds, investment banks or insurance companies.

2001-'03: Alan Greenspan's Fed dropped federal-fund rates to 1%. Lulled into a false belief that inflation was not a problem, the Fed then kept rates at 1% for more than a year. This set off an inflationary spiral in housing, and a desperate hunt for yield by fixed-income managers.

2003-'07: The Federal Reserve failed to use its supervisory and regulatory authority over banks, mortgage underwriters and other lenders, who abandoned such standards as employment history, income, down payments, credit rating, assets, property loan-to-value ratio and debt-servicing ability. The borrower's ability to repay these mortgages was replaced with the lender's ability to securitize and repackage them.

2004: The SEC waived its leverage rules. Previously, broker/dealer net-capital rules limited firms to a maximum debt-to-net-capital ratio of 12 to 1. This 2004 exemption allowed them to exceed this leverage rule. Only five firms -- Goldman Sachs, Merrill Lynch, Lehman Brothers, Bear Stearns and Morgan Stanley -- were granted this exemption; they promptly levered up 20, 30 and even 40 to 1.

2005-'07: Unscrupulous home appraisers found that they could attract more business by inflating appraisals. Intrinsic value was ignored, so referrals kept coming in. This helped borrowers obtain financing at prices that were increasingly unsupportable. When honest appraisers petitioned both Congress and the bureaucracy to intervene in the widespread fraud, neither branch of government acted.

THERE'S ACTUALLY A LOT MORE we could add to these items. We could mention impotent supervision of Fannie and Freddie by the Office of Federal Housing Enterprise Oversight; the negligent oversight on ratings agencies; the Boskin Commission's monkeying around with how inflation gets measured; the "Greenspan Put," etc.

We could mention former Fed Governor Edward Gramlich, who warned about making home loans to people who could not afford them, and who said the runaway subprime-mortgage industry would create problems in housing and the credit markets. But Gramlich was up against a Fed chairman who apparently believed that markets can regulate themselves. (Gramlich died last year, three months after the housing bubble started to deflate.)

We on Wall Street do not deny our part. We created these securities, we rated them triple-A, we traded them without understanding them. Now that they have gone bad, we are real close to getting the rest of the country to take them off our hands.

Thanks, D.C. None of this would have been possible without you.

Very truly yours,
Wall Street

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