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The Financial Crisis of 2008: The Main Players, Causes, Chain of Events, and How America Can Move Forward

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Wall Street, from the moment of its inception, "had been there to serve Main Street, and it took that role seriously" (McGee, 2010, p. 5), as well as serving as one of the cornerstones of the capitalistic economy in the United States. As the years passed, Wall Street changed from being "an intermediary to a self-serving, risk-taking machine for generating profits" (McGee, 2010, pg. 7) that ultimately led to its near extinction in the year 2008. Greed and profits flooded the Street and became the driving factor for the investment and commercial banks, which rewarded them handsomely in good economic times, but no one was prepared for what would happen when the markets began to decline. The one culprit for these high-yielding profits was the mortgage backed security- which were packaged and then cut into smaller pieces, and packaged again and again until the banks and the CEOs, let alone the public, knew the value of the assets that were supposed to be backing them (Mayo, 2012, p. 85). With the added risk, comes the added potential for profits, which the Street was capitalizing on prior to 2008; in the year 2000 mortgage backed securities (MBS) related transactions reached $690.7 million, which skyrocketed to $2.3 billion by the year 2006 (McGee, 2010, p. 159). What came next climaxed at a feeling of sheer panic not only in America, but across the globe, where a loss of confidence crept into the minds of investors, along with hard feelings regarding bailouts, government assistance, and what *Too Big To Fail* author Andrew Ross Sorkin called popular media's tendency to "pit Wall Street against the nation's soccer moms" (2009, p. 32). Wall Street is based heavily on earnings reports and inevitably rumors on the Street. Alan Greenberg, the former chairman of Bear Stearns, summed it up best when he said, "Bad news, whether it derives from false rumor or verifiable fact, then has an alarming capacity to become contagious and selfperpetrating" (McLean & Nocera, 2010, p. 347). The financial crisis had several key components, or causes, that played a part in this historical downfall- everyone from the loan officers, the lenders and the naïve potential homeowners to the investment banks and their CEOs to the rating agencies and regulators. This paper will start by looking at each of the key causes for the financial crisis, which will then be followed by a condensed play by play of the chain of events that happened from the "government assistance" of Bear Stearns, the bankruptcy of Lehman Brothers, and the government intervention that has changed the role of the federal government on Wall Street forever. At the conclusion of the paper the decision to "bailout" the investment banks and merging them with commercial banks, emphasizing the fact of now being "too big to fail," will be evaluated, as well as looking toward the future and how the decisions made in 2008 will shape Wall Street and our economy in the future. Americans can learn a great deal about the economy, and realize that while it might be easy to point a finger at one particular cause for the corruption on Wall Street, the interconnectedness of the banks on the Street do not allow for such a simple accusation to be made- many players have played a role in the end of Wall Street as Americans all once knew it.

The American Dream has always been to own a house since home ownership would suggest "upward mobility, opportunity, a stake in something that matters" (McLean & Nocera, 2010, p. 6). The government also believed in the American Dream, which is why the Housing and Urban Development (HUD) department mandated that 42%, 50%, and 56% of loans that were bought by the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) must go to people with low or moderate incomes (Johnson & Kwak, 2010, p. 145). Availability of credit began to grow, and this brought more and more potential home owners into the market (Goldberg & Giedeman, 2009, p. 15). With the added prevalence of MBS, the housing market was booming, people were able to take out affordable mortgages, and the investment banks were in turn bundling the mortgages and selling them to other investors and making huge profits off them. The issue was that Wall Street, Americans, and even the head of the Treasury department, Henry Paulson felt that "Housing prices hadn't declined on a nationwide basis since the Great Depression! People always paid their mortgages" (McLean & Nocera, 2010, p. 249), and therefore there would be no downside to this housing market. The amount of funding available shifted Americans' mentality on housing- they began to think like speculators- treating homes like investment assets- flipping homes, and in turn taking out equity lines on the houses for boats and other expensive lifestyle choices. This model began to collapse once housing values began to drop- people began walking away from their homes, voluntarily defaulting. This in turn left the banks holding homes that were worth less than the mortgage was for, and the banks on Wall Street holding highly rated MBS that were now declining in value as well. Jamie Dimon, the CEO of JP Morgan Chase, picked up on the severity of the Americans defaulting on their mortgages- especially since he realized even people current on their credit card debts and auto loans were walking away from their mortgages and their houses (Lowenstein, 2010, p. 79). In the movie version of Andrew Ross Sorkin's book *Too Big To Fail*, the mentality among Americans during the time of these affordable mortgages was that, "If the banks are willing to loan me this mortgage, I must be able to afford it" (Hanson, 2011). While the banks and lenders, as we will see later, share the blame, one cannot but become frustrated with the naivety among Americans. While the banks have mortgages that may appear attractive, the belief that "things too good to be true, are" (Hanson, 2011), applies in this situation. If the prospective homeowners looked a little closer at the mortgages they were signing on for, looking closely at the interest rates they were being given- including the dreaded adjustable rates- they might have been more skeptical and questioned the loan officers they were dealing with. This is the beginning of the domino effect on Wall Street, since the investment banks now have MBS losing value, as well as Freddie Mac and Fannie Mae holding mortgages that were acting as collateral for MBS and now left with all the risk. Elizabeth Warren took the approach that Americans were tricked into getting these mortgages- whether subprime or not- and that “the mortgage won’t even carry a disclosure of [the possibility of default] to the homeowners” (Johnson & Kwak, 2010, p. 198). While many share Elizabeth Warren’s perspective with wanting the banks to be solely responsible, Americans must realize that with any loan or mortgage they take out, they are responsible for making their payments and know that the risk of defaulting is always there if they are unable to make the payments. Next we will examine the role of the lenders at the commercial banks in the crash of the housing market.

The lenders were motivated by profits, and the key to making profits was to increase the volume of loans they were processing. They had several enticing aspects to their loans that made them more appealing to the public including an adjustable rate mortgage (ARM) - which would only benefit the borrower if rates went down, not up- as well as a “pay option” that allowed borrowers to pay less than the monthly interest on loan- which in the long run made the principal balance go up over the time of the loan (Johnson & Kwak, 2010, p. 127). The lenders also accepted smaller down payments, and increased loan to value (LTV) ratios- which meant that the collateral they had would not be sufficient to protect the lender from default unless the housing prices continued to go up- which everyone assumed would continue to happen (Johnson & Kwak, 2010, p. 127). Along with the aforementioned priority of the American Dream and trying to get as many Americans to own their own home, lenders turned toward subprime loans, which in turn lowered their standards for “creditworthiness, capacity, or collateral” (Johnson & Kwak, 2010, p. 127). These subprime loans paid higher interest rates and they were crucial to manufacturing the high-yielding collateralized debt obligations (CDOs) that were also being packaged by the investment banks (Johnson & Kwak, 2010, p. 127). The mortgage originators received their fees up front, so there was little financial incentive to make sure that borrowers would not default in the future (Goldberg & Giedeman, 2009, p.17), as well as the fact that the Wall Street banks were demanding more of these mortgages in order to compile them into CDOs and MBS to sell and yield the high interest rates associate with higher risk. Additionally, the appraisers of the properties had little incentive to give a correct appraisal; often they would appraise the house higher than what it was worth in order to keep their job with the mortgage originator (Goldberg & Giedeman, 2009, p. 17). In the book *The End of Wall Street*, the author gives a specific example of how at Washington Mutual in their mortgage origination offices a loan officer double checked with the bank and discovered that an applicant who said they had $150,000 in income in reality only had $50,000. Shockingly, the head loan officer was furious that he double checked this, and enforced the mentality that "a thin file is a good [loan] file" (Lowenstein, 2010, p. 33), or as long as what the applicant puts on the application looks good, the bank would not second guess what they had on paper. As the housing prices started to plummet, and Americans were being left with negative equity in their houses, the defaults began, and as early mortgage payment defaults started to increase, borrowers were essentially defaulting from the moment they signed off on the loan (McLean & Nocera, 2010, p. 251). Short term profits, and the interdependency of the banks and the appraisers on the loan originators, led to a difficult predicament in terms of giving mortgages to Americans who should not have qualified.

The investment banks and insurance firms had several issues within their firms that contributed to the causes of the economic crisis: utilizing complex securities that no one understood or knew the values of the underlying assets, undercapitalization, a focus on short-term profits that encouraged increased risk levels taken on by the firm, and pride in the institution to the extent that they were invincible. First, the complex securities being traded and bundled by the firms were so complex that even the CEOs and the board of directors did not understand them (Sorkin, 2009, p. 3). This should have been a red flag, along with the fact that the investors knew nothing about the underlying asset or the value of that asset. Investors who were buying the risky mortgage paper knew nothing about the underlying assets, and instead “high ratings replaced independent judgment” (Lowenstein, 2010, p. 46). Besides the MBS, the firms were also utilizing an instrument known as a credit debt obligation which was built out of the MBS or securities backed by other assets, while offering high returns with relatively little risk- at least according to the models being used (Johnson & Kwak, 2010, p. 124). Like any asset backed security, when the initial asset starts to lose value, the corresponding asset-backed security would need to be written down. When the assets and CDOs were initially valued, they were valued looking at historical correlations with statistics, which was risky and unreliable- especially given the sudden change in the housing market (Lowenstein, 2010, p. 44-45). Another type of security that was utilized by insurance giant AIG was the credit default swap (CDS) which insured any pool of mortgage loans of MBS while “seemingly eliminating the risk of default” (Johnson & Kwak, 2010, p.125). Along the same line of a CDO, the model AIG was using to value these swaps did not take into account what would happen when the values of the underlying assets and MBS started to sink. Martin Sullivan, AIG’s chief executive, was reluctant to mark the assets down because he felt the loss would devastate his firm’s stock and credit rating (Lowenstein, 2010, p.121). AIG “treated swaps like an all-win, no-loss business- violating every tenet of sound insurance” (Lowenstein, 2010, p.121). Due to the decline in the value of the securities, the other firms started making collateral calls to AIG to cash in their insurance contracts. This brings up the second issue with the investment and insurance firms- they did not keep enough collateral or capital in their reserves. They were caught up in the fact that the economy was doing well and that they could earn huge profits by investing in everything they could. When the investment firms starting running out of capital, they turned to AIG for collateral calls because they began to get worried that AIG would not be able to make good on their promise to offset losses on the CDOs and they wanted the cash up front (Lowenstein, 2010, p.112). The problem was that AIG did not hold cash as collateral either, it invested its cash reserves in mortgage-backed bonds with an average life of 10-12 years, which were already losing value to begin with so there was no cash available for the firms who wanted it in 20-30 days (Lowenstein, 2010, p.154). To demonstrate the amount of exposure AIG had with the financial firms, AIG had sold its CDS protection (which is a type of unregulated insurance due to it being a new instrument) to all the major Wall Street firms to amount to $1 trillion of exposures with 12 major financial institutions (Sorkin, 2009). Timothy Geithner, the president of the Federal Reserve of New York, defended the firm's collateral calls saying, "I cannot advise a bank not to protect itself" (Sorkin, 2009, p. 281).

The third issue the investment and insurance firms had was that they were focused on short-term profits, which led to increased risk taking. Dick Fuld of Lehman Brothers felt that his firm's approach was "too conservative" and wanted the firm to take a more aggressive approach than they had in the past by getting involved in commercial real estate, mortgages, and leveraged lending (Sorkin, 2009, p. 28). Peter Solomon brought up a fact that will be mentioned throughout the paper that "it might be argued that public ownership and the compulsion to increase earnings per share propels employees toward greater risk" (McGee, 2010, p.170). When firms are rewarded for short-term profit generation at the expense of long-term investments and the interest of the firm, this leads to abuses (McGee, 2010, p.197). While the current Obama administration is working on finding ways to change the regulation of Wall Street, the nature of the banks being publicly traded was not addressed in any of his plans to curtail risk (McGee, 2010). Another firm that took on increased risk was Merrill Lynch, where Stan O'Neal pushed the firm to take on more risk even though the institution had a $50 million loss. John Breit, a risk manager, talked about the " 'schizophrenia' in the firms' approaches to risk [which] caused traders to seek out risks that wouldn't show up in the risk models," (McLean & Nocera, 2010, p.236) which would in turn would increase the exposure to both the upsides and downsides to increased risk. Last, the thought that the firms were 'invincible,' and that they always knew what was best ended up hurting them in the long wrong. In *The End of Wall Street*, Roger Lowenstein talks about Dick Fuld at Lehman Brothers and how he ignored all the warning signs and refused to cut back on risk because it would suggest "that luck, rather than Fuld's leadership, had been responsible for Lehman's success" (2010, p. 80). It was also Fuld who became very 'picky' over what offers he would accept from potential buyers of his firm as Lehman was heading toward bankruptcy. Fuld's pride in himself and his firm prevented him from taking a "low" offer from Warren Buffet, where Fuld's character in the documentary/movie *Too Big To Fail* exclaims: "Lehman Brothers is not Bear Stearns…I'm not giving this company away" (Hanson, 2011). The leaders of the firms had never given the public, nor the government, any reason to doubt them in the past, even allowing a U.S. Government Accountability Office (GAO) report to show that regulators "acknowledged that they had relied heavily on management representation of risks" (McLean & Nocera, 2010, p. 243). Poor decisions, along with a desire for short-term profits, undercapitalization, using investments that were so complex and risky that they could not be rated or valued properly, led to the downfall of these firms- with Lehman Brothers going into bankruptcy and others being rescued by the government. The precedent set by the government when they saved Bear Stearns brought up the concept of moral hazard, which is what occurs when risk-takers are shielded from the consequences of failure, which might inspire them to take on even more risk. This moral hazard that presented itself on Wall Street after the government saved Bear Stearns would come back to haunt them as Lehman Brothers became complacent with their thinking that the government would swoop in and save them. This idea of moral hazard along with fear seeped into the firms on Wall Street and will be discussed again toward the end of the paper when the discussion of the bailouts and government capital injections comes into play.

The investment banks relied heavily on the rating agencies and the ratings they gave to their bonds, MBS, and CDOs. To demonstrate the great importance of a rating, in *Too Big To Fail* it was noted that in the case of insurance giant AIG, "if their Standard & Poor's or Moody's lowered its rating by one notch, AIG would be required to post $10.5 billion in additional collateral, if both agencies lowered their ratings, the damage would soar to $13.3 billion" (Sorkin, 2009, p. 226)- the severity being in the fact that they did not have enough in collateral to be able to come up with these massive amounts. Standard & Poor's and Moody's are the primary rating agencies used, and they received this job when the government outsourced their regulatory function to these agencies in order to set a "grade" for investments, in order for the SEC to monitor brokers who held their bonds a less than desirable grade (Lowenstein, 2010, p. 39-40). How do these rating agencies have the authority to be given the massive responsibility of looking at these complex financial instruments, being able to understand them, and then give them a rating that everyone would accept as being accurate? The CEO of Moody's at the time of the crisis was Brian Clarkson and in the book *All the Devils are Here*, his intentions for the rating agency were outlined, emphasized by an "agenda [to use] structured finance to boost revenues, market share, and- above all- Moody's stock price" (McLean & Nocera, 2010, p.115). This is a perplexing predicament over what the objective of a rating agency should be, instead of being caught up in making sure the "issuers…were happy with the ratings they got" (McLean & Nocera, 2010, p. 115). One can see where the disparity could occur in terms of how to rate the MBS, especially as there was no due diligence done on the underlying mortgages, and additionally the feeling that it would be "extremely unlikely" that all BBB bonds would default- so top rated CDO tranches instead got AAA ratings (Goldberg & Giedeman, 2009, p. 14). While this may upset the general person, nobody at the time wanted to reform the rating agencies- the investment banks wanted to make sure they got triple-A ratings, and the investors themselves would rather get their ratings from an agency (never minding how they arrived at their conclusions) than doing all the work themselves (McLean & Nocera, 2010, p. 120). The corruption within these rating agencies allowed for complex financial instruments to be given higher ratings than they should have, thus clouding the investors judgments as to whether the assets backing the securities were indeed considered "secure" and "free from the possibility of default." The rating agencies were later turned to when the housing prices continue to drop and the securities that were rated highly began to plummet in value, thus raising the question as to whether the rating agencies and their quest for short-term profits clouded their approach to completing due diligence and the necessary research to rate such important securities- much like the mortgage originators overlooking unqualified loan applicants in place of short-term windfall profits. Unfortunately for both, the short-term profits were later replaced with huge losses that could have been avoided if they took better care with using stricter judgment and looking at long-term outcomes versus the short-term.

The question also arises in regards to the regulators and auditors as to whether they too should have taken extra care in completing their work that could have alleviated some of the damage caused by the financial crisis. While market purists call for no regulation on Wall Street, instead believing that the invisible hand will guide the market in the best direction, there were some regulations in place, although not as many as the public would have liked. The issue that comes forward is whether increased regulation would have helped in this case- would the regulators have been able to understand the complex securities (the same ones even the CEOs could not understand); and would the regulators have been able to resist the pressure from the politicians and the banks when they told the regulators they were doing fine and had the necessary safety mechanisms already in place (Johnson & Kwak, 2010, p. 207)? The mindset of the regulators during 2008 was that they “wanted a peaceful and uncomplicated life” (McGee, 2010, p. 173), which would involve not being put into positions of high stress, as well as having a reckless indifference to the risks in the market. In terms of subprime lending, this type of lending was pushed by the federal government to give affordable housing to more Americans, so it became a “gray” area in terms of what message it would send to the public and the market if the federal government needed to step in and increase regulation on those mortgages (McLean & Nocera, 2010). Going forward, the author of *Chasing Goldman*, Suzanne McGee, stressed that American needs effective regulation, which requires smart individuals who would spot trends, analyze them, and see whether they pose any threats, as well as being able to stand up to the pressure from the banks (2010). In terms of the auditors, there is a conflict of interest in place since they are hired, fired, and paid by the company. Mike Mayo talks about a situation in his book *Exile on Wall Street* where an auditor found that the company overstated its earnings, and instead of correcting it, they increased their tolerance for misstatements by 50% (2012, p. 153). Not all of the auditors do this of course, and in the book *The End of Wall Street*, it talks about how AIG's auditor PricewaterhouseCoopers questioned how AIG valued their swaps, and forced them to revise values on their financial statements even though it resulted in a $5.3 billion quarter loss (Lowenstein, 2010, p. 113). An article entitled "The 2008 Financial Meltdowns: Were Early Warning Signs Detected and Disclosed by Management and Auditors?" further researched the auditing procedures used and determined that the auditors lacked the detailed procedures and documentation provided in going concern standards, and that they also had to deal with the inevitable resistance by the clients to include a going concern disclosure (Lindquist & Drogt, 2012). Overall, the primary problem both the regulators and auditors faced is the balance between providing transparency to the market and standing up to the client while not giving into pressure to not make the necessary changes and disclosures that might have been able to give the public some type of warning signs. Mike Mayo summed up the problem in a quote from his book *Exile on Wall Street* that could apply to regulators and auditors alike: "[they are] always considering problems in the rearview mirror. The financial system today is almost dizzying complex and moving at light speed, and new rules tend to address fairly precise things" (2012, p. 147-148). While it is important to look at reforming the regulation on Wall Street, and looking at ways to change the audit model in order to have results with more details and risks documented, it could be inferred that even if these changes had been in place, the speed with which the chain of events happened in 2008 could have kept the auditors and regulators from being able to gather information quickly enough to understand what was occurring and relay that to the public.

Echoing a popular sentiment among those who worked on Wall Street, John Mack the CEO of Morgan Stanley said, “We are in a market today where rumor and innuendo are much more powerful than real results” (Lowenstein, 2010, p. 224). This idea of rumors was often magnified by the actions and trades executed by the short sellers and hedge fund managers on Wall Street. The reasoning behind shorting a stock is essentially betting that the stock of the entity will decrease in price rather than increasing in price, which allows the shorts to make money off this decrease in price. When the rumors began to spread throughout the Street of whether a bank was in financial trouble, or whether bankruptcy was in the near future, the hedge funds would begin shorting the stocks of these banks, thus sending a message to the investors on the Street that these hedge funds felt that these banks were going under in the future. For example, hedge fund managers, after they saw what happened to Bear Stearns, began to pull brokerage accounts, bought insurance against the banks in the form of credit default swaps (CDS), and began shorting the stocks of many of the major investment banks including Lehman Brothers. These short-selling trades enraged the CEOs of the investment banks because they felt that “short sellers cared only about their own profits and gave little thought to their impact on the system” (Sorkin, 2009, p. 82). It could also be damaging to the investment banks as they were working hard to keep up the morale in their institution and in the public’s perception of their institution, all while there were hedge fund managers who were using shorts as a way to instill even more fear and panic into the investors and the public. Even if the rumors were true or not, it was giving the hedge funds an unfair opportunity of “controlling” what the public’s perception was of the stability of the banks and where they were going. Many of the investment banks called for the SEC to put a ban on short sellers, which would have increased the way the government was already involved in the crisis on Wall Street. This request came after the

Financial Services Authority in the United Kingdom announced a 30 day ban on short selling 29 financial stocks (Sorkin, 2009, p. 438-439). The United States worked on a plan of their own and had Chris Cox of the SEC crack down on improper short selling of shares in Lehman Brothers, Fannie Mae, Freddie Mac, and 17 other financial firms (Sorkin, 2009). The market responded favorably to this, and it gave the banks and financial firms the opportunity to set their own records straight without the stress of dealing with the short sellers and how they could influence the state of mind of the investors. This temporary ban on short selling brought up the controversial opinion of whether short selling should be outlawed and whether it was the shorts that were responsible for the "rapid decline in bank shares" (Goldberg & Giedeman, 2009) in 2008. While the short selling may have magnified the decline in the bank shares, the added call for regulation of short selling would bring up the topic of whether having too much government intervention in what the Street can and cannot do from executing trades, using market predictions to execute their trades, and the like. While the shorts and hedge fund managers played a role in the financial crisis, it would be unfair to outlaw the financial method of shorting shares all together.

In the midst of the beginning stages of the financial crisis, the public and media were looking for an easy target to blame- the "people wanted blood" (McLean & Nocera, 2010, p. 360). Their targets were the public faces of the banks on Wall Street- the CEOs. Not only were the CEOs seen as being in control of every action taken by their firms, the knowledge of their millions of dollars in bonuses while the future of their firms were going up in smoke did not sit well with most of the public on Main Street. AIG, the insurance giant that received government assistance, paid out $165 million in bonuses (McLean & Nocera, 2010, p. 360). Martin Sullivan, the chief executive at AIG, even asked the board of directors to disregard the losses when calculating his bonus. Even when executives were being removed from their positions they were still able to keep their bonuses, as in the case of Joseph Cassano, the swaps chief at AIG, who got to keep his $34 million bonus even though Sullivan dismissed him from his position (Lowenstein, 2010, p. 122). It was also found out that when Bank of American and Merrill Lynch were working on their deal, John Thain of Merrill Lynch accelerated the payment of $3.6 billion in bonuses to the employees at Merrill Lynch the day before the deal went through (McLean & Nocera, 2010, p. 360). The issue of the motivation for personal profits by the CEO was also questioned, and whether this desire clouded the judgment of steps being taken within his or her firm. For example, when Stanley O'Neal was brought in as Merrill Lynch's CEO, the goal of the firm was to raise their return on equity (ROE). The compensation policy at the firm was based around this goal of increasing the share price and increasing the ROE, in turn pushing Merrill Lynch away from their "reliant" business of simply underwriting and selling stocks and bonds (McGee, 2010, p.153). The compensation structure changes came about as the financial firms changed from being closely held partnerships to publicly traded entities (McGee, 2010, p. 182). The bonus culture moved the excess profits the firms had in good times to employees in the form of bonuses rather than putting them into capital reserves (Johnson & Kwak, 2010, p. 183), again not thinking with a long-term frame of mind.

The firms also felt the pressure from hedge funds and private equity funds on the Street and had to compete with them in order to retain newcomers and offer enticing salaries and bonuses to the people at the firm who could generate revenue for the firm (McGee, 2010, p. 196). The CEOs were already under a lot of pressure as the economy began to collapse, and to add to their downfall was their portrayal in the media as all being full of greed, not caring at all about the future of their firms, and being labeled as such solely because of criticism over the bonuses and salaries they received in their positions. In *Chasing Goldman Sachs* the point is brought up that there is a "tolerance for millionaires and people making money as long as they're performing; if they believe they got their money through fraud, deception or at the expense of 'little guy on Main Street', then their perception changes" (McGee, 2010, p. 186). Suzanne McGee goes on to bring up the idea that the problem overall on Wall Street has "less to do with the sheer magnitude of the salary and bonus checks than those on Main Street might have believed" (2010, p. 182). The issue should not have been whether or not the amount of the bonuses and salaries were too much, but instead of whether the compensation structures used by the firms were using short-term goals as a way to measure how much they should make, leading to excessive risk taking as an incentive for increasing the value of the firm. Wall Street views their compensations as being warranted since they put in long hours, have complex jobs, and no work-life balance (McGee, 2010, p. 179-180). Since not every person has the education, knowledge, or personality that could handle this type of job, the companies needed to make it appealing to those who could do the work, and in order to do this they must offer competitive salaries and bonuses. There needs to be a move toward analyzing and changing the current compensation policy on Wall Street so that it is not so dependent on short-term profits, which would cut back on the incentive to take on great amounts of risk all at once in order to increase the stock price. John Mack at Morgan Stanley came up with an idea that future compensation should be based on "multi-year performance and each employee's contribution to the firm's sustainable profitability" (McGee, 2010, p. 201). The dialogue of changing the compensation model is an important one, and it will help eliminate unhealthy incentives to put increasing one's compensation above the financial stability and performance of the firm. While the CEOs certainly played a role in the economic crisis in terms of putting their personal financial concerns ahead of those of the firm they worked for, it appears that the actual underlying culprit may have been the employee compensation models themselves, and not necessarily the "evil tendencies" of the CEOs that the public wanted to believe.

The federal government set a precedent, whether they realized it or not, the moment they assisted Bear Stearns by agreeing to take on up to $30 billion of losses from Bear's worst assets. Bear Stearns had agreed to be sold at $2 a share to JP Morgan in order to avoid filing bankruptcy, but they needed outside assistance in dealing with the "bad" assets in order to make a deal between the two firms work (Sorkin, 2009, p. 10). The attention soon turned to Fannie Mae, a government-sponsored entity, where due to the housing market crash, the firm was in deep financial trouble. In the *Too Big To Fail* movie, there is a scene that documents an exchange between the Chinese and Henry Paulson, the Treasury Secretary, where they talked about how the Russians were trying to persuade the Chinese to work with them to dump all of Fannie Mae and Freddie Mac's bonds onto the market at once, which would absolutely devastate the United States economy since these firms did not have that kind of capital available (Hanson, 2011). The United States had to step in and drew up terms where the government would acquire $1 billion of new preferred senior shares in each of Freddie and Fannie, and would give it 79.9% of common shares of each. The government would also contribute as much as $200 billion into both companies if necessary (Sorkin, 2009, p. 229). "The Fed said no to New York City in 1975 and no to Chrysler in 1979…but with the Bear Stearns precedent, it will not be so easy to say no the next time…we will not know the limits to Fed lending until the Fed says no to a large, influential firm seeking help (Sorkin, 2009, p. 263)." This next large, influential firm would happen to be Lehman Brothers. The country was watching the government's moves in dealing with Lehman, especially because Henry Paulson's previous job was acting as the Chief

Executive Officer and Chairman of Goldman Sachs and President Bush had family ties to Lehman Brothers, with the street and the media ready to pounce on any opportunity to say that the government was choosing sides in allowing a strong competitor to go under, but saving others. The other issue regarding the state of Lehman Brothers was Dick Fuld's reluctance to accept any offer made to him for his firm from the private sector. Fuld did not accept Warren Buffet's offer feeling that is was too low; as well as disagreeing with Bank of America because Fuld felt they should pay at least $25 a share, which Ken Lewis felt was much too high considering Lehman closed that day at $18.32 (Sorkin, 2009). Lehman Brothers then came up with a solution of their own which it presented known as the "spin plan"- where the firm would be divided in two parts- the "good bank" which it would keep and a "bad bank" which it would spin off, ridding themselves of their worst real estate assets (Sorkin, 2009, p. 213). The problem with this idea was that "the new company would likely need to be funded. Where was Lehman going to come up with the money to accomplish that when it needed to retain as much capital as possible?" (Sorkin, 2009, p. 256). The most promising bidder was Bob Diamond, a chief executive of the British bank Barclays who told Fuld that his bank would be interested in purchasing Lehman. However, what Fuld, nor Diamond, realized was that Barclays needed a 30 day board approval of the Lehman deal, and the British regulators would not agree to make any type of exception. Once Henry Paulson realized that this deal with Barclays was not going to be able to go through in time before the markets open and devastate Lehman's stock and the rest of the firms on Wall Street even further, Paulson told Lehman that the government strongly suggests that they file for bankruptcy immediately. Dick Fuld had thought in the back of his mind that the government would step in and help his firm like they helped Bear Stearns, even though Paulson had said in a press conference that "Bear Stearns [is] different than Lehman"

(Sorkin, 2009, p. 386) and reiterating that there was no money. It was on Monday September 15, 2008 that Lehman Brothers officially filed for bankruptcy, with Barclays soon coming with interest in purchasing the assets from the firm that it wanted- the U.S. broker-dealer components and its buildings (Sorkin, 2009, p. 378). The reaction from many after Paulson made the decision not to bailout Lehman Brothers was generally positive. A New York Times editorial heralded Paulson's decision saying: "government intervention would have been seen either as a sign of extreme peril in the global financial system or of extreme weakness on the part of the federal regulators" (Sorkin, 2009, p. 389-390). If Paulson thought that the decision to not bailout Lehman Brothers would be the most difficult decision he would have to face, he did not realize how much worse things would get.

The next problem was with the insurance giant AIG because it was being confronted by all the other banks to pay off the swaps that it used to insure the MBS and CDOs all at the same time. Due to AIG's investing activities getting out of control, it did not have the cash necessary to make good on these obligations. At first Paulson was reluctant to get involved, but given the severity of the situation and the exposure AIG had, not getting involved would devastate all the banks interconnected with the insurance giant. The government gave AIG a credit line of $85 billion in exchange for 79.9% ownership in the form of "equity participation notes" (Sorkin, 2009). This government intervention came despite Timothy Geithner saying that "There's no government money for this…Lehman's bankruptcy was Exhibit A" (Sorkin, 2009, p. 388). Seeing that the government helped the insurance giant, the other firms began to feel confident that they too would be getting government help in order to offset the losses and lack of cash they had due to the declining value of all their asset-backed securities. It was as if the whole world was watching to see which firm would be the next to fall- Merrill Lynch, Goldman Sachs, Wells

Fargo, Bank of America, the possibilities were numerous. Back when Lehman Brothers was fighting for its life before its bankruptcy, Paulson brought all the CEOs of the major commercial and investment banks together in order to try to find a private market solution- whether anyone would buy Lehman or parts of Lehman- which did not work out. Now, Paulson urged the banks to try and talk with each other to try and find a way to merge or find any other way within the private market- without government dollars- to keep the firms on Wall Street alive. Merrill Lynch ended up selling to Bank of American for $29/share, which was coincidentally one of the largest premiums in the history of banking mergers (Sorkin, 2009, p. 359). Morgan Stanley entered into a $9 billion deal with Mitsubishi, Goldman Sachs took a deal with Warren Buffet, and JP Morgan paid $1.9 billion for Washington Mutual (Sorkin, 2009). Citigroup and Wachovia were in the midst of negotiating a deal where Citigroup would buy Wachovia for $1/share with the FDIC guaranteeing Wachovia's toxic assets after Citigroup accepted the first $42 billion of losses (Sorkin, 2009, p. 498). This deal fell through, much having to do with Citigroup only offering $1/share for Wachovia, while Wells Fargo entered into a counter bid for Wachovia at $7/share and no government assistance. Despite these mergers, there was still the problem with lack of cash, capital, and confidence within the banks.

The banks were holding on to any bit of cash they had instead of lending it out, while the consumers were also holding on to their moneys instead of investing it or spending it to help stimulate the economy. The government moved toward gaining support for its Toxic Asset Relief Program (TARP) which would involve the U.S. Treasury purchasing up to $700 billion of toxic assets, such as illiquid mortgage backed securities, in an effort to try and stabilize the economy and bring confidence back to the market (Sorkin, 2009, p. 442). The first attempt failed, but the act passed through Congress and the Senate the second time with some additions/clarifications including having the government have an equity stake in the firms participating, as well as limits on employee compensation. President George W. Bush signed the "Emergency Economic Stabilization Act of 2008" on Friday October 3, 2008, which put the stamp of approval on the $700 billion TARP. The TARP money was given to the firms on the condition that the government purchased 20% in preferred stock in each participating firm. Henry Paulson was fearful of the term "capital injection" because of his fear of "nationalizing" the banking industry, and how the market and country would react to that action (Hanson, 2011). However, he felt it important to give the banks capital through buying stakes of the firms through preferred shares, so that they could start loaning it out to the consumers again. He gave the following amounts to the following banks in return for their shares: $25 billion to Bank of America, $25 billion to Citigroup, $10 billion to Goldman Sachs, $25 billion to JP Morgan, $10 billion to Morgan Stanley, $10 billion to State Street, and $25 billion to Wells Fargo. The hope was that the banks would start lending out this money, but there were not many restrictions placed on this additional capital due to the fear that the CEOs would not accept the money- especially if it involved the government becoming too involved in their business. In the book *The End of Wall Street*, the author Roger Lowenstein refers to Henry Paulson as a "reluctant socialist", since he allowed the banks to continue giving dividends and wanted to work hard to restore confidence in the shareholders of the banks (2010, p. 270) while still allowing the government to intervene. The line between too many guidelines and not enough guidelines because of fear in how the banks would react was a very thin one. The result was that the banks did not begin loaning out this money right away; some even gained media exposure for instead using the money to pay for employee and executive compensation. The bailout of these banks could be considered a necessary evil- the "private markets were helpless" and they needed to have someone come in to rescue them- in this case, the federal government. While the bailout act was put together in a hurried manner and might not have reached all the objectives that they hoped it would, the state of the economy if the government had not stepped in would be one of much greater devastation than the United States could have been prepared for. The critics of the bailouts feel that government intervention is taking away from the free market idea, while others are critics of this particular TARP bailout plan because they feel it gave the banks too much leeway on how to use the funds paid for in part through taxpayer dollars. While this bailout act was not a flawless execution, it gave the banks the time and money it needed to start to regain its strength and most importantly, working toward instilling confidence in its shareholders, the market, and the consumers on Main Street.

"Too big to fail"- this is the phrase that is known in popular media to describe the current state of the investment banks on Wall Street after the 2008 financial crisis. The big banks are so large now and can take on more risk than competitors "since creditors and counterparties know that the government will clean up after them" (Johnson & Kwak, 2010, p. 191). The future role of the government on Wall Street is still unknown, but due to the "capital injections" of the large financial firms, the Fed placed its balance sheet at great risk, and in order to take control of this risk, the government would need more controls on Wall Street as the federal government becomes more and more involved in cleaning up the mess left behind from the economic crisis (Lowenstein, 2010, p. 132). One of problems that the banks need to confront in the future in order to avoid future devastation is the idea of the banks being undercapitalized- in *The End of Wall Street*, the author Roger Lowenstein claims that capitalists forgot that "capitalism requires capital" and this is an important factor for the banks to keep in mind going forward. However, after the initial bailouts in 2008, "nervous bankers were hoarding capital" (2010, p. 240) and not using the money given to them in the capital injections to loan out to the consumers. The consumers were also playing a role in attempt to stabilize the economy- the public was investing in government securities where the rates were effectively zero, sending a message to Wall Street that they would rather accept a zero return on their savings in return for the guarantee safety of their savings (Lowenstein, 2010, p. 221-222). Americans who were once hooked on spending credit were now saving instead, and had no interest in taking out loans or lines of credit. In turn, shopping decreased and the retail markets suffered; Starbucks alone had to close 900 stores during this time (Lowenstein, 2010, p. 274). The federal government was the "protector", but there was not much the Fed could do in terms of the lack of borrowers in the market after 2008. The other issue brought up through the economic crisis involves the idea of a capitalistic economy and whether it is still considered a successful model to base a country's economy around.

Mike Mayo wrote in his book *Exile on Wall Street* that "it's not that capitalism does not work- it does, provided there's enough transparency and sufficient information for everyone to see and understand what's really going on" (2012, p. 163). This call for transparency is one of the changes that many would like to see implemented on Wall Street, a "change that compels companies to better apply accounting rules base on economic substance versus surface presentation (Mayo, 2012, p. 149). Mayo goes on to say that "instead of trying to control what banks do, I think we should let them off the leash but make the results more public, more transparent, and easier to understand" (2012, p. 149). The thinking is that if the results are easier to understand to not only the general public, but to the regulators and the members of the financial institution themselves, then they would be able to better forecast what would happen in the future as well as keeping a close eye on any potential activities being taken on that are focused on short-term profits versus the long term success of the firm. Some others call for banks to be heavily regulated and not allowed to take on risk in order to keep the desire for profits at a minimum. However, John Mack at Morgan Stanley is quick to point out that "we cannot and should not take risk out of the system- that is what drives the engine of our capitalist economy" (McGee, 2010, p. 371). Going along the same lines of the possibility of moving away from capitalism is the idea of greed and whether greed is good for an economy, particularly if it motivates CEOs and executives to make decisions that would only benefit them. It is unfair to require Wall Street to take a detached view of greed- all professions no matter what it is desire money (McGee, 2010, p. 211). The country cannot also call for all of Wall Street to collapse just because some members behave foolishly- it would not be good for the economy on Wall Street, Main Street, and across the globe (McGee, 2010, p. 296). Instead, the firms need to focus on finding a fine balance between using risk to increase the profits they make for their clients and from taking on projects so the firm itself comes out on the better side. Tom McNamara, a private equity manager, calls for an idea where compensation is "paid when the things you sell pay off for the people that buy them, not when you sell them" (McGee, 2010, p. 209) and this in turn will be tied to the success of the client (instead of only the success of the firm) and will uphold the system's well-being. Ideas like this coming from Wall Street is a step in a positive direction as they need to be addressed so that the banks do not become as reckless with their borrowing and lending or so reliant on increasing their bottom line for short periods at a time as they did in 2008. Wall Street works for its clients, but like any business they also work for themselves, that is the reality as of the current state of our country. It is not correct to call for a complete overhaul in the way they do business, but ethics and a look inside at the motivation behind their actions is critical in making the necessary changes to move forward. The role of the government in trying to rectify these things have developed an idea of a “new normal”- an economy with a weaker dollar, greater government presence in business, more joblessness, and higher taxes (Lowenstein, 2010, p. 295). While the government made the choice to step in to save the banks on Wall Street, in doing so they have set themselves up for the idea in every person’s mind that every time a firm makes a mistake that the government will be there to pick up the pieces. It is not fair to assume that this will happen every time, especially since 2008 and the speed and magnitude with which it occurred had a great deal of intricate players, including the government itself, that the banks were not solely at fault, and therefore deemed not able to be allowed to fail. America is now left with the “Big Six” on Wall Street- Morgan Stanley, Goldman Sachs, Wells Fargo, Citigroup, JP Morgan, and Bank of America, banks that will continue to try and get the consumers to become more confident in the banking system so that they can begin to loan again.

The early signs of Wall Street trying to get back on its feet recently have been positive ones as they are beginning to make credit available, and more importantly the public are beginning to spend more. The progress has been dismal and slow at best, due in part by the high unemployment rate, but as we begin to move forward the government, the banks, Wall Street, the regulators, auditors, lenders, and the public needs to educate themselves on how 2008 culminated into the tragedy that it did and how we need to work hard to keep history from repeating itself. Blame can be shifted in several different directions, but the reality is that “Main Street’s need for Wall Street is the reason that Wall Street exists” (McGee, 2010, p. 378) in the first place. While the banks are now considered to be “too big to fail”, it is now imperative for the financial institutions to show the public that they are capable of finding the right balance between risk taking and making profits for their clients without becoming self-obsessed; and it is time for the public to call for Wall Street to become more transparent with the activities they are investing and involving themselves in so that America works toward repairing the financial system that so many countries had looked to as a model on how to run their own economy. Insight and reforms are necessary to uphold our economy, but having the government fully invested in the state of Wall Street also needs to be monitored so that it does not jeopardize the capitalistic state of our economy. There needs to be a balance in place between the regulations necessary to be enforced by the government and the internal regulations that need to be implemented by the firms themselves. In order to properly implement the changes referenced in the past two paragraphs the issue of a single institution and its ability to affect the entire United States economy if it failed needs to be addressed and whether having smaller firms that compete with each other would benefit the consumers rather than having banks that are so large and have such a stronghold on the economic and political power in the country (Johnson & Kwak, 2010, p. 183). While there is no correct answer as how to address this, the steps are being taken in the correct direction in terms of requiring more transparency and accountability, changing compensation policies, and working toward the success of the end customer. It sometimes takes a wakeup call as severe as the one America received with the bursting of the housing bubble, the subprime mortgage collapse, and the government intervention with the banks on Wall Street to shed light on the current problems. Now it is our job and duty to work toward rectifying these problems and upholding the institution of Wall Street in our capitalistic economy here in the United States of America.

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