Too Big to Fail Book Summary, by Andrew Ross Sorkin

by Allen Cheng


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Too Big to Fail is a detailed account of the personalities and decisions that led to the 2008 financial crisis and how the economy was propped up. Andrew Sorkin has compiled a number of insightful primary sources from the major players that allows us to get a glimpse of the backroom warnings, arguments, and deals in that turbulent time. The choices these key players made led to a major impact on outcome of the 2008 crisis.

At the time, 2007 was seen as a year of triumph in Wall Street. Major investment banks had made enormous profits on speculative investment strategies that carried serious underlying risk. However, few were listening to these signs because of how well the current approaches had paid off. The entire finance industry garnered $53B in compensation overall. Top CEOs were paid enormous bonuses, such as CEO of Goldman Sachs Lloyd Blankfein receiving $68M for 2007 alone. Banks all around were preparing for another windfall in 2008.
Causes

In early 2008, investment bank Bear Stearns was rescued by JPMorgan Chase at fire sale prices. Bear Stearns had overextended and taken on an unsustainable amount of debt. This shocking event revealed that Wall Street investment banks might not have such a rosy position. Treasury Secretary Henry Paulson phoned a warning to Lehman Brothers CEO Richard S. Fuld Jr that Bear Stearns might be the beginning, and that the same could happen to Lehman Brothers.

In prior months, Fuld initially seemed to be aware of the risks his aggressive approaches entailed. Yet as the profits kept snowballing, he took on more and more leverage for increasingly risky deals and seemed to go into denial as to how much risk Lehman actually had. Despite having its debt to equity ratio boosted to 30.7 to 1, Fuld insisted their balance sheet was excellent and publicly blamed short-sellers for the wild swings of its stock. Some of Lehman’s employees were also aware of the exceptional risks the firm was taking. However, none of them were willing to speak up due to fear that their criticism would be taken as disloyalty by Fuld’s right-hand man Joseph Gregory.

When he finally realized Lehman’s troubles, Fuld shopped around for a buyer, but none were interested in the firm's increasingly overleveraged assets. Lehman valued its loans and investments at $42B, but others believed it was probably under half of that figure. He asked the government for assistance, but was deemed in denial and was rejected. British regulators did not want any of their banks to try to buy out Lehman and get the U.K. infected by its “cancer.”

Lehman went bankrupt in September 2008, greatly escalating the crisis. Fuld, along with many other Lehman executives, had a large proportion of his networth wrapped up in Lehman stock. When the firm went bankrupt, he personally lost over half a billion dollars. He had been employed by Lehman Brothers since 1966. The spectacular failure of Lehman Brothers was not due to its management lacking skin in the game or industry experience. Rather, the ease of previous years’ profits had made them unable to properly evaluate their increasingly very risky and overly leveraged deals.

Lehman was hardly the only senior Wall Street manager who reacted too late to the crisis. The top management of AIG, an insurance giant, also believed their firm was not at risk. They could point to a profitable insurance business, $40B in cash, and $1T in assets. However, it was later revealed that they had made several bad insurance bets on subprime mortgages that called all the above figures into
question. In late 2008 their losses mounted to $5B, five times what they had previously estimated.

Wall Street and Federal Reserve Actions

An escalation of responses was a consistent overall pattern of reactions towards the growing crisis. Initial decisions that might have made an important impact in stemming the bleeding and allaying the overall fears of the market were delayed until they were too late. This meant not only escalating the degree of aid necessary to save the system, but also bringing in bigger players. The amount of federal money involved meant that the President would have to be briefed and Congress called in. Both of these parties would have to approve the enormous initial $700B bailout package.

In the panic and uncertainty, political appearances negatively affected decision making. Paulson was apparently so stressed that he would dry heave during the workday. He struggled with handling accusations by critics that he was a socialist or “Mr. Bailout.” For instance, after hearing these critiques he rejected Barclays bank’s offer to work with the government to buy Lehman Brothers, and allowed Lehman Brothers to go under without support. As the crisis grew worse and began to impact more parties, he would have to change his stance.

Firms quickly rose or fell depending on the overall perception towards them. Some top leaders, such as JPMorgan CEO Jamie Dimon, prepared for the collapse of all the major investment banks. Confidence and some semblance of certainty provided by an external gesture went a long-way to help quell fears. For instance, Goldman Sachs was able to stave off disaster by enticing Warren Buffett of Berkshire Hathaway with advantageous terms to invest $5B into the firm. That signal led other investors to buy another $5B, keeping Goldman afloat. Merrill Lynch took an even more drastic approach: they sold the entire firm to the Bank of America.

Other firms, however, were unable to lure private investors to save them. Deprived of external aid, they could only rely on the government to keep them afloat. Few people were sure of what exactly the government intended, as the Federal Reserve’s strategy was not totally congruent. AIG, desperate for assistance, offered to sell its property and casualty business to Warren Buffett for $20-25B. Buffett rejected the proposal, leaving AIG’s options limited. The amount of money they needed to survive required a mammoth investor, a consortium of investors, or the government. The Fed elected to help them. After Paulson consulted with President Bush and informed him of the possible damage to the overall economy, the Fed extended an $85B credit line to AIG while acquiring a majority of the firm
Put in context, the Fed had allowed Lehman to fail it, but then saved AIG. This decision was made to attempt to calm the market and give increasingly nervous investors confidence that the system would not collapse. However, investors reacted with confusion rather than confidence. Why was Lehman allowed to fail, but AIG needed a bailout? How would the Fed react regarding the next domino to wobble? A serious problem compounding the issue was the inability for different parties to agree on how much certain complicated assets were actually worth. Without that understanding, private investor deals fell through.

The uncertainty forced the Fed to escalate the bailout to the entire banking system, though it was still unclear how they should implement the bailout. The original plan was to purchase $500B of toxic assets (assets which nobody was willing to buy at the moment) of the floundering banks. This bill, the Troubled Asset Relief Program, was initially rejected by Congress. The market responded with the single largest daily fall in history at that time, 777 points. The Fed then adjusted its approach to invest $700B in bank ownership instead of just buying the assets outright. A revision added tax breaks, raised the FDIC insurance limit, and it was passed by Congress and the President.

Paulson was quickly taking center stage of the crisis in the eye of the nation: Newsweek called him “King Henry.” The government had to completely take over the mortgage companies Freddie Mac and Fannie Mae, which had also taken unsustainable risks during the housing bubble. His next step was to assemble 9 of the top CEOs of Wall Street banks at a private meeting, along with the Federal Reserve Chairman Ben Bernanke and the head of the New York Federal Reserve, Timothy Geithner. The governmental team pushed for the banks to buy $250B worth of preferred shares from the government to help boost confidence in the market and ensure there wouldn’t be another Lehman Brothers-level failure.

Not all of the Wall Street CEOs assembled at the meeting were on board. Some banks were in much worse positions than others. The leaders of Wells Fargo and JPMorgan Chase saw it as bad for their banks that had stayed afloat so far, while helping their rivals that had made mistakes. However, all 9 leaders eventually agreed to the plan for the good of the system.

Many important individuals had made serious mistakes and were slow to recognize the true gravity of the crisis. However, the willingness of the Fed to escalate its response and the cooperation of the remaining bankers helped stem the bleeding and gradually overcome the crisis.