By Elizabeth Bloomer Nesvold

Who'll Be Left Standing?

Those banks and investment experts who weather this perfect financial storm surely will be stronger. But how much wiser?

On Feb. 20, 2008, my husband, Peter Nesvold—a newly minted partner at Bear, Stearns & Co. Inc.—came home and said, "I think my firm is going bankrupt."

I told him he was crazy, that Bear Stearns had one of the strongest balance sheets on Wall Street. And I teased him about being the poster child for doom and gloom. Peter had been predicting the sky would fall since early 2005. That was when he examined our five-year adjustable rate mortgage and concluded that our monthly payments would double in 18 months with only a 300 basis point move in mortgage rates. At the time, Peter called our banker to confirm his math. She told him he was right but said, "Don't worry—you'll be able to refinance." He hung up the phone and told me we should eliminate our debt and sell our oversized, jumbo-mortgaged house. We did. After all, a three-person family doesn't *really* need a 17-room house; it was just too cavernous to call "home."

If only more people had run the numbers, looked at them realistically, and taken concrete steps to address obvious problems in their capital structure, maybe Bear Stearns and a few other venerable institutions would still be in business. The questions are: Why didn't they? Why did the Wall Street cookie crumble?

"Leverage" is, of course, the short, easy answer.

"Culture" is the more complicated explanation.

Elizabeth Bloomer Nesvold is managing partner of Silver Lane Advisors in New York

Blow Out

Turns out Bear Stearns had a debt-to-equity ratio of nearly 30-to-1. When two of Bear's highly "levered"[1] hedge funds imploded, clients got spooked and unrestrained deleveraging drained the firm. It was the proverbial run on the bank.

Remember how actor Jimmy Stewart as George Bailey in the movie *It's a Wonderful Life* pleaded with his customers as they were crowding into his Building & Loan to withdraw all of their money: "The money's not here. Your money's in Joe's house right next to yours and a hundred others. Why, you're lending them the money to build, and then, they're going to pay it back to you as best they can. Now what are you going to do? Foreclose on them?"

Well, Jimmy Stewart was able to stave off a mass withdrawal and keep his thrift's doors open, but Bear Stearns was not so fortunate. Apparently, Bear's customers were thinking less like George Bailey and more like Warren Buffett, who once said, "Should you find yourself in a chronically leaking boat, energy devoted to changing vessels is likely to be more productive than energy devoted to patching leaks."[2]

Bear Stearns went from solvency to insolvency in a matter of a week. When your balance sheet is levered 30-to-1 and the rumor mill is hard at work, clients lose faith in your business—perception becomes reality. Bear couldn't "delever"[3] fast enough to return clients' money and suffered what seems to have been a government-sponsored sale at the final share price of $10 to J.P. Morgan.[4]

Bear Stearns wasn't the only one to fall. Lehman Brothers is gone; Merrill Lynch, too. Goldman Sachs and

1 1/6/09 9:55:17 AM

Morgan Stanley—two of the most prominent investment banks—were pressured to become bank holding companies. No firm wants to sign up for tighter regulatory scrutiny. But Goldman and Morgan obviously found it attractive to have access to the Federal Reserve's emergency funds and have the ability to use deposits to buttress investment banking activities.

Wait a minute . . . didn't the government split commercial and investment banking activities in the 1930s, after concluding that banks had been using their deposits to buttress *bad* investments? Such a setup was clearly a bad idea then, how could it possibly be a good idea now?

Perhaps Buffett was right when he said, "If past history was all there was to the game, the richest people would be librarians."[5] Pundits will argue the model will, indeed, work better, because a regulatory tidal wave is forming on Capitol Hill to ensure that the financial sector maintains an appropriate risk profile and capital structure. Welcome to Glass-Steagall on steroids.

The Ruins

But all that's in the future. Right now, we're still picking over the wreckage. As with the investment banks, seemingly solid commercial banks have simply shattered; the world's largest insurer lays in ruins.

In July of 2008, IndyMac Bancorp, a California commercial and mortgage bank, was seized by regulators after a major run by depositors. But the bank's $32 billion that transferred to the FDIC didn't compare to the failure that would come next. Washington Mutual was the first national bank to fail during this crisis. In fact, WaMu's demise represented the largest bank failure in U.S. history, weighing in at $307 billion in assets—more than nine times the size of IndyMac.

Wachovia was the next major bank pushed to the brink by the credit crisis; trying to avoid WaMu's fate, it was forced onto the block. The regulators pushed an arranged marriage with Citigroup, who offered $1 per share, with a backstop on loan losses by the FDIC. The overlap in business lines and geographic coverage would have made for a synergy bloodbath; tens of thousands might have been laid off.

Wachovia senior management had another suitor in mind. With their encouragement, Wells Fargo offered to play white knight—so long as a tax change would allow it to retain Wachovia's net operating losses (NOL), post-transaction. At roughly $6 per share *before* the NOL benefits,[6] Wells Fargo's pricing made the K-Mart blue light specials look expensive. Citi cried foul, with an argument that amounted to nothing more than "honor

Changes in the world of life insurance often benefit the industry, ***not*** your client.

Simply Advice

The Insurance Design Center is committed to getting the truth out to the advisor community so that you can proactively defend and protect your clients' best interests.

Our fee-based engagements provide unbiased consultation, third party analysis and written recommendations for the prudent management of life insurance.

We are a dedicated resource to trust and estate advisors, trustees and family offices across the country. IDC is not affiliated with any insurance company and sells no product. We simply offer advice.

Let us show you how to prevent your clients from falling victim to the changes that are silently impacting billions in assets.

THE INSURANCE DESIGN CENTER, LLC

500 Lake Cook Rd. Suite 270 Deerfield, IL 60015 Tel: 866 943 6900 InsuranceDesignCenter.com

 1/6/09 9:55:20 AM

among thieves." Ultimately, though, Citi walked away from the fight—perhaps to focus on challenges in its own business. At press time, Citi's own future was far from certain.

As if all these disasters weren't enough, we can expect to count the insurance industry among the financial casualties. Already, American International Group, the world's largest insurer, has fallen victim to the credit crunch, as its triple-A credit rating was downgraded, requiring it to post collateral with trading counterparties. Shareholders watched the stock freefall from a 52-week high of $62.30 to a low of $1.25—a staggering, nearly 98 percent drop. With bankruptcy looming, the Fed intervened, initially offering a two-year credit facility of $85 billion in the form of a convertible preferred that will deliver 80 percent of the dividends and *pro rata* voting power. (At press time, the credit facility had been renegotiated and extended to $150 billion.)

The jury is still out as to whether this was a smart move, because majority ownership by the government may preclude fresh capital sources from making additional investments. With a share price that seems to be hovering in the $2.00 range post-infusion, one share of AIG buys you a ride on a New York City subway . . . at least, for now. Subway fares may be going up and AIG's share price, down.

The Future

Once again, a quote from Buffett is apt. "In the business world," Buffett has quipped, "the rearview mirror is always clearer than the windshield."

Problem is, I'm not convinced that we're all looking in the same rearview mirror when we look at 2008's economic collapse. Too many politicians claimed Wall Street was out to cheat Main Street. But now that the presidential and senate elections are over, maybe even they can admit: While some Main Streeters surely were duped, too many others were simply negligent. Indeed, a lot of Subprime Joes were hoping to get something for nothing. They knew they had no business buying a house with no money down and taking an additional credit line to do renovations. One hundred and ten percent debt sure was one heck of a deal—or was it?[7]

Culpability is everywhere. As with the tech bubble of the 1990s, too many people were willing to suspend reason. Sure, it's obvious that tech stocks weren't supposed to go up 20 percent every week. But as long as they did, no one complained. Anyone who asked questions was told they didn't get the "New Economy." Then, of course, the bubble popped.

You'd think we'd learn a lesson from the 1990s. But, no. What the nation did in the 2000s was—lather, rinse, repeat—create a housing bubble. And, sure enough: Pop! As Yogi Berra was fond of saying, "It's like deja vu, all over again."

We don't know yet what financial turmoil the nation may experience in the coming year. Clearly, it's too early to draft the full "lessons learned" report. But, already, we know at least one truism has been proven yet again: Diversification is essential. We all watched in 2001 as the demise of Enron financially ruined employees locked into the concentrations of the company stock. Yet, in 2008, we saw that tens of thousands of employees of financial institutions held concentrated positions in their companies' stock—many of them willingly—as the companies failed. The irony here: some of these people were the very professionals who did a phenomenal job of diversifying clients' portfolios and sparing their clients from the full impact of the market disaster. Apparently, when it came to their own financial planning, they were the shoemaker's children walking around shoeless.

Seems crazy, right? Unfortunately, it makes a lot of sense. Here's the "cultural" explanation: For many financial services professionals, stock concentration was simply Wall Street's way. "Believe in your company" was the credo and the best way to show that confidence was by *not* selling shares.

Several years ago, our financial advisor asked, "How would we like to address the Bear Stearns restricted stock as it vests?" Even my cautious, savvy husband said "I probably won't sell it."

His perspective was partially analytical: Bear's book value had grown every quarter for more than 80 years. And the stock had the lowest valuation multiples of its Wall Street peers. But his view was also partially emotional: many of the wealthiest and most successful partners at

3 1/6/09 9:55:20 AM

the firm had never sold a share in their careers.

Nearly a third of Peter's annual bonus was delivered in the form of Bear Stearns stock. Like many Wall Street firms, Bear had four-year restrictions on selling any shares. What is particularly "challenging" about restricted stock vehicles is that the individual is taxed at ordinary income rates at the time the stock grants, then forced to hold the stock. If stock participants were lucky enough to sell it later, the write-off is at a lower capital loss rate and limited by the level of capital gains in the year plus $3,000.

Talk about timing and rewards. Many Bear and Lehman alums will have tax loss carryforwards for the rest of their lives, with the whopping $3,000 annual deduction against taxable income.

We're far from alone and not the hardest hit. I spoke recently to someone who came to me through the Bear alumni. He'd been with Lehman while his wife was at Bear. They lost most of their concentrated stock value, even though Lehman fell a full six months after Bear. How could *that* happen?

Well, he confessed, at first, "I truly believed that Bear Stearns had to go to save Lehman." (Honestly, we all did, even the government.) Then, having watched their Bear holdings drop to a fraction of its value, his wife urged him to sell their Lehman stock when it, too, started to nosedive. He had the chance to liquidate a portion at $30—but didn't. He said he just couldn't bear to take such a loss on the stock and hoped for the best outcome for the firm. Much to his chagrin, the loss he ultimately suffered was 100 percent. For this family's finances, it was like having two Mack trucks plow into the same car. What are the chances?

No one can predict who'll be among the last financial institutions standing. But some firms have clearly benefited from this chaos: J.P. Morgan acquired Bear Stearns; Bank of America now has Merrill; Wells Fargo has Wachovia; Barclays has pieces of Lehman; and BNY Mellon is the money administrator for the Fed's Troubled Assets Relief Program. For clients of larger institutions, the firm's financial stability and ability to offer credit may be the litmus test for maintaining the relationship. But the independent advisors also will benefit from dramatic inflows of clients—if not today, then soon. These days, clients want the kind of objectivity, transparency and freedom of conflict that independent firms offer.

Moreover, with all the "downsized" bodies littering Wall Street, opportunistic firms both large and small will surely enjoy the greatest hiring opportunities seen in the last several decades. Whereas once the wealth management industry was worried about replicating senior talent in a Petri dish, now such individuals are like low-hanging fruit, just waiting to be picked. Some firms are using this environment as an opportunity to upgrade their staffs. Mediocre talent, move over.

As Yogi Berra once said "It's hard to make predictions, especially when they are about the future." While the markets aren't testing new lows of late, few people believe the recovery has commenced. But many expect that those who weather this perfect financial storm will forge stronger firms, benefitting from a new set of market opportunities.

Welcome to the New Wall Street.

Now, let's all pay very close attention to what *its* cultural norms become. TE

Endnotes

1. "Lever" is Wall Street's vernacular for "leverage." It seems to me that somewhere in the mid-1990s, Wall Streeters started dropping the "—age" and saying "lever" for "leverage" and "delever" for "de-leverage." The evolution of these words certainly is a good, timely topic for the likes of *The New York Times* lexicologist Russell Baker to investigate.
2. Warren E. Buffett, *The Essays of Warren Buffett: Lessons for Corporate America*, Carolina Academic Press, 2008.
3. "Delever" means "unwinding leverage."
4. J.P. Morgan's original offer was $2 a share— a price that stunned Wall Street, as it didn't even cover the fair market value of Bear's corporate headquarters.
5. *Supra* note 2.
6. The net operating loss (NOL) tax benefit was estimated at $19.4 billion. Wells Fargo issued stock in the amount of $15.1 billion to Wachovia shareholders. While there are limits on the amount of taxable income that can be offset by NOLs, the math suggests pretty favorable after-tax deal pricing.
7. Back in the 1990s during the tech bubble, school teachers left their jobs to become day traders. During the real estate bubble, financially unsophisticated people were suddenly in the business of flipping houses. Witness all the reality shows like A&E's "Flip This House" and TLC's "Flip That House." The real estate bubble was fueled in part by Average Joes' real estate speculation gone wild.

4 1/6/09 9:55:20 AM