Behind Biggest Insurer’s Crisis, A Blind Eye to a Web of Risk

By GRETCHEN MORGENSON

Two weeks ago, the nation’s most powerful regulators and bankers huddled in the Lower Manhattan fortress that is the Federal Reserve Bank of New York, desperately trying to stave off disaster.

As the group, led by Treasury Secretary Henry M. Paulson Jr., pondered the collapse of one of America’s oldest investment banks, Lehman Brothers, a more dangerous threat emerged: American International Group, the world’s largest insurer, was teetering. A.I.G. needed billions of dollars to right itself and had suddenly begged for help.

The only Wall Street chief executive participating in the meeting was Lloyd C. Blankfein of Goldman Sachs, Mr. Paulson’s former firm. Mr. Blankfein had particular reason for concern.

Although it was not widely known, Goldman, a Wall Street stalwart that had seemed immune to its rivals’ woes, was A.I.G.’s largest trading partner, according to six people close to the insurer who requested anonymity because of confidentiality agreements. A collapse of the insurer threatened to leave a hole of as much as $20 billion in Goldman’s side, several of these people said.

Days later, federal officials, who had let Lehman die and initially balked at tossing a lifeline to A.I.G., ended up bailing out the insurer for $85 billion.

Their message was simple: Lehman was expendable. But if A.I.G. unspooled, so could some of the mightiest enterprises in the world.

A Goldman spokesman said in an interview that the firm was never imperiled by A.I.G.’s troubles and that Mr. Blankfein participated in the Fed discussions to safeguard the entire financial system, not his firm’s own interests.

Yet an exploration of A.I.G.’s demise and its relationships with firms like Goldman offers important insights into the mystifying, virally connected — and astonishingly fragile — financial world that began to implode in recent weeks.

Although America’s housing collapse is often cited as having caused the crisis, the system was vulnerable because of intricate financial contracts known as credit derivatives, which insure debt holders against default. They are fashioned privately and beyond the ken of regulators — sometimes even beyond the understanding of executives peddling them.

Originally intended to diminish risk and spread prosperity, these inventions instead magnified the impact of bad mortgages like the ones that felled Bear Stearns and Lehman and now threaten the entire economy.

In the case of A.I.G., the virus exploded from

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a freewheeling little 377-person unit in London, and flourished in a climate of opulent pay, lax oversight and blind faith in financial risk models. It nearly decimated one of the world’s most admired companies, a seemingly sturdy insurer with a trillion-dollar balance sheet, 116,000 employees and operations in 130 countries.

“It is beyond shocking that this small operation could blow up the holding company,” said Robert Arvanitis, chief executive of Risk Finance Advisors in Westport, Conn. “They found a quick way to make a fast buck on derivatives based on A.I.G.’s solid credit rating and strong balance sheet. But it all went out of control.”

The London Office

The insurance giant’s London unit was known as A.I.G. Financial Products, or A.I.G.F.P. It was run with almost complete autonomy, and with an iron hand, by Joseph J. Cassano, according to current and former A.I.G. employees.

A onetime executive with Drexel Burnham Lambert — the investment bank made famous in the 1980s by the junk bond king Michael R. Milken, who later pleaded guilty to six felony charges — Mr. Cassano helped start the London unit in 1987.

The unit became profitable enough that analysts considered Mr. Cassano a dark horse candidate to succeed Maurice R. Greenberg, the longtime chief executive who shaped A.I.G. in his own image until he was ousted amid an accounting scandal three years ago.

But last February, Mr. Cassano resigned after the London unit began bleeding money and auditors raised questions about how the unit valued its holdings. By Sept. 15, the unit’s troubles forced a major downgrade in A.I.G.’s debt rating, requiring the company to post roughly $15 billion in additional collateral — which then prompted the federal rescue.

Mr. Cassano, 53, lives in a handsome, three-story town house in the Knightsbridge neighborhood of London, just around the corner from Harrods department store on a quiet square with a private garden.

He did not respond to interview requests left at his home and with his lawyer. An A.I.G. spokesman also declined to comment.

At A.I.G., Mr. Cassano found himself ensconced in a behemoth that had a long and storied history of deftly juggling risks. It insured people and properties against natural disasters and death, offered sophisticated asset management services and did so reliably and with bravado on many continents. Even now, its insurance subsidiaries are financially strong.

When Mr. Cassano first waded into the derivatives market, his biggest business was selling so-called plain vanilla products like interest rate swaps. Such swaps allow participants to bet on the direction of interest rates and, in theory, insulate themselves from unforeseen financial events.

Ten years ago, a “watershed” moment changed the profile of the derivatives that Mr. Cassano traded, according to a transcript of comments he made at an industry event last year. Derivatives specialists from J. P. Morgan, a leading bank that had many dealings with Mr. Cassano’s unit, came calling with a novel idea.

Morgan proposed the following: A.I.G. should try writing insurance on packages of debt known as “collateralized debt obligations.” C.D.O.’s were pools of loans sliced into tranches and sold to investors based on the credit quality of the underlying securities.

The proposal meant that the London unit was essentially agreeing to provide insurance to financial institutions holding C.D.O.’s and other debts in case they defaulted — in much the same way some homeowners are required to buy mortgage insurance to protect lenders in case the borrowers cannot pay back their loans.

Under the terms of the insurance derivatives that the London unit underwrote, customers paid a premium to insure their debt for a period of time, usually four or five years, according to the company. Many European banks, for instance, paid A.I.G. to insure bonds that they held in their portfolios.

Because the underlying debt securities — mostly corporate issues and a smattering of mortgage securities — carried blue-chip ratings, A.I.G. Financial Products was happy to book income in exchange for providing insurance. After all, Mr. Cassano and his colleagues apparently assumed, they would never have to pay any claims.

Since A.I.G. itself was a highly rated company, it did not have to post collateral on the insurance it wrote, analysts said. That made the contracts all the more profitable.

These insurance products were known as “credit default swaps,” or C.D.S.’s in Wall Street argot, and the London unit used them to turn itself into a cash register.

The unit’s revenue rose to $3.26 billion in 2006 from $737 million in 1999. Operating income at the unit also grew, rising to 17.5 percent of A.I.G.’s overall operating income in 2005, compared with 4.2 percent in 1999.

Profit margins on the business were enormous. In 2002, operating income was 44 percent of revenue; in 2005, it reached 83 percent.

Mr. Cassano and his colleagues minted tidy fortunes during these high-cotton years. Since 2001, compensation at the small unit ranged from $423 million to $616 million each year, according to corporate filings. That meant that on average each person in the unit made more than $1 million a year.

In fact, compensation expenses took
a large percentage of the unit’s revenue. In lean years it was 33 percent; in fatter ones 46 percent. Over all, A.I.G. Financial Products paid its employees $3.56 billion during the last seven years.

The London unit’s reach was also vast. While clients and counterparties remain closely guarded secrets in the derivatives trade, Mr. Cassano talked publicly about how proud he was of his customer list.

At the 2007 conference he noted that his company worked with a “global swath” of top-notch entities that included “banks and investment banks, pension funds, endowments, foundations, insurance companies, hedge funds, money managers, high-net-worth individuals, munipalities and sovereigns and supranationals.”

Of course, as this intricate skein expanded over the years, it meant that the participants were linked to one another by contracts that existed for the most part inside the financial world’s version of a black box.

Goldman Sachs was a member of A.I.G.’s derivatives club, according to people familiar with the operation. It was another of A.I.G.’s credit insurers and also acted as an intermediary for trades between A.I.G. and its other clients.

Few knew of Goldman’s exposure to A.I.G. When the insurer’s flameout became public, David A. Viniar, Goldman’s chief financial officer, assured analysts on Sept. 16 that his firm’s exposure was “immaterial,” a view that the company reiterated in an interview.

Later that same day, the government announced its two-year, $85 billion loan to A.I.G., offering it a chance to sell its assets in an orderly fashion and theoretically repay taxpayers for their trouble. The plan saved the insurer’s trading partners but decimated its shareholders.

Lucas van Praag, a Goldman spokesman, declined to detail how badly hurt his firm might have been had A.I.G. collapsed two weeks ago. He disputed the calculation that Goldman had $20 billion worth of risk tied to A.I.G., saying the figure failed to account for collateral and hedges that Goldman deployed to reduce its risk.

Regarding Mr. Blankfein’s presence at the Fed during talks about an A.I.G. bailout, he said: “I think it would be a mistake to read into it that he was there because of our own interests. We were engaged because of the implications to the entire system.”

Mr. van Praag declined to comment on what communications, if any, took place between Mr. Blankfein and the Treasury secretary, Mr. Paulson, during the bailout discussions.

A Treasury spokeswoman declined to comment about the A.I.G. rescue and Goldman’s role. The government recently allowed Goldman to change its regulatory status to help bolster its financials amid the market turmoil.

**An Executive’s Optimism**

Regardless of Goldman’s exposure, by last year, A.I.G. Financial Products’ portfolio of credit default swaps stood at roughly $500 billion. It was generating as much as $250 million a year in income on insurance premiums, Mr. Cassano told investors.

Because it was not an insurance company, A.I.G. Financial Products did not have to report to state insurance regulators. But for the last four years, the London-based unit’s operations, whose trades were routed through Banque A.I.G., a French institution, were reviewed routinely by an American regulator, the Office of Thrift Supervision.

A handful of the agency’s officials were always on the scene at an A.I.G. Financial Products branch office in Connecticut, but it is unclear whether they raised any red flags. Their reports are not made public and a spokeswoman would not provide details.

For his part, Mr. Cassano apparently was not worried that his unit had taken on more than it could handle. In an August 2007 conference call with analysts, he described the credit default swaps as almost a sure thing.

“It is hard to get this message across, but these are very much handpicked,” he assured those on the phone.

Just a few months later, however, the credit crisis deepened. A.I.G. Financial Products began to choke on losses — though they were only on paper.

In the quarter that ended Sept. 30, 2007, A.I.G. recognized a $352 million unrealized loss on the credit default swap portfolio.

Because the London unit was set up as a bank and not an insurer, and because of the way its derivatives contracts were written, it had to put up collateral to its trading partners when the value of the underlying securities they had insured declined. Any obligations that the unit could not pay had to be met by its corporate parent.

So began A.I.G.’s downward spiral as it, its clients, its trading partners and other companies were swept into the drowning pool set in motion by the housing downturn.

Mortgage foreclosures set off questions about the quality of debts across the entire credit spectrum. When the value of other debts sagged, calls for collateral on the securities issued by the credit default swap sidelines A.I.G. Financial Products and its legendary, sprawling parent.

Yet throughout much of 2007, the unit maintained that its risk assessments were reliable and its portfolios conservative. Last fall, however, the methods that A.I.G. used to value its derivatives portfolio began to come under fire from trading partners.

In February, A.I.G.’s auditors identified problems in the firm’s swaps accounting. Then, three months ago, regulators and federal prosecutors said they were investigating the insurer’s accounting.

This was not the first time A.I.G. Financial Products had run afoul of authorities. In 2004, without admitting or denying the allegations, it helped clients improperly burnish their financial statements. A.I.G. paid $126 million and entered into a deferred prosecution agreement to settle federal civil and criminal investigations.

The settlement was a black mark on A.I.G.’s reputation and, according to analysts, distressed Mr. Greenberg, who still ran the company at the time. Still, as Mr. Cassano later told investors, the case caused A.I.G. to improve its risk management and establish a committee to maintain quality control.

“That’s a committee that I sit on, along with many of the senior managers at A.I.G., and we look at a whole variety of transactions that come in to make sure that they are maintaining the quality that we need to,” Mr. Cassano told them. “And so I think the things that have been put in at our level and the things that have been put in at the parent level will ensure that there won’t be any of those kinds of mistakes again.”

At the end of A.I.G.’s most recent quarter, the London unit’s losses reached $25 billion.

As those losses mounted, and A.I.G.’s once formidable stock price plunged, it became harder for the insurer to survive — imperiling other companies that did business with it and leading it to stun the Federal Reserve gathering two weeks ago with a plea for help.

Mr. Greenberg, who has seen the value of his personal A.I.G. holdings decline by more than $5 billion this year, dumped five million shares late last week. A lawyer for Mr. Greenberg did not return a phone call seeking comment.

For his part, Mr. Cassano has departed from a company that is a far cry from what it was a year ago when he spoke confidently at the analyst conference.

“We’re sitting on a great balance sheet, a strong investment portfolio and a global trading platform where we can take advantage of the market in any variety of places,” he said then. “The question for us is, where in the capital markets can we gain the best opportunity, the best execution for the business acumen that sits in our shop?”
An Insurance Giant, Brought Down

A tiny unit at American International Group ... 

... was well compensated by A.I.G. Financial Products, which sold complex financial contracts, called credit derivatives.

Source: A.I.G. company reports

![Bar chart showing A.I.G.F.P. Employee Compensation](chart1.png)

The world's largest insurer was brought to the edge of bankruptcy by its small London unit A.I.G. Financial Products, which insured people and properties against natural disasters and wrote policies for generating a significant share of revenue from selling contracts that protected clients from losses on debt.

But as certain debt losses mounted, A.I.G. was forced to increase its own financial cushion and write down the value of some of its own holdings ...

![Chart showing Value of Corporate Debt Insured by A.I.G.F.P.](chart2.png)

The unit became profitable enough in February to pay $126 million and enter into a deferred prosecution agreement that A.I.G. Financial Products had run afoul of authorities. A.I.G.'s reputation and, according to analysts, distressed Mr. Greenberg, who later pleaded guilty to six felony charges — Mr. Cassano helped start the London unit in 1987.

![Chart showing A.I.G.F.P. Insured $513 Billion of Debt Against Default Using Credit-Default Swaps](chart3.png)

When A.I.G.'s credit ratings were downgraded Sept. 15, the need for more money on hand increased beyond what it could borrow, and it asked the Federal Reserve for help.
U.S. MAY TAKE OWNERSHIP STAKE IN BANKS TO EASE CREDIT CRISIS

Taking Hard New Look at a Greenspan Legacy

“Not only have individual financial institutions become less vulnerable to shocks from underlying risk factors, but also the financial system as a whole has become more resilient.” — Alan Greenspan in 2004

By PETER S. GOODMAN

George Soros, the prominent financier, avoids using the financial contracts known as derivatives “because we don’t really understand how they work.” Felix G. Rohatyn, the investment banker who saved New York from financial catastrophe in the 1970s, described derivatives as potential “hydrogen bombs.”

And Warren E. Buffett presciently observed five years ago that derivatives were “financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal.”

One prominent financial figure, however, has long thought otherwise. And his views held the greatest sway in debates about the regulation and use of derivatives — exotic contracts that promised to protect investors from losses, thereby stimulating riskier practices that led to the financial crisis. For more than a decade, the former Federal Reserve Chairman Alan Greenspan has fiercely objected whenever derivatives have come under scrutiny in Congress or on Wall Street. “What we have found over the years in the marketplace is that derivatives have been an extraordinarily useful vehicle to transfer risk from those who shouldn’t be taking it to those who are willing to and are capable of doing so,” Mr. Greenspan told the Senate Banking Committee in 2003. “We think it would be a mistake” to more deeply regulate the contracts, he added.

Today, with the world caught in an economic tempest that Mr. Greenspan recently described as “the type of wrenching financial crisis that comes along only once in a century,” his faith in derivatives remains unshaken.

The problem is not that the

Continued on Page A29
THROUGH FOUR ADMINISTRATIONS

The derivatives market is $531 trillion, up from $106 trillion in 2002 and a relative pittance just two decades ago. Theoretically intended to limit risk and ward off financial problems, the contracts instead have stoked uncertainty and actually spread risk amid doubts about how companies value them.

Mr. Greenspan had acted differently during his tenure as Federal Reserve chairman from 1987 to 2006, many economists say, the current crisis might have been averted or muted.

Over the years, Mr. Greenspan helped enable an ambitious American experiment in letting market forces run free. Now, the nation is confronting the consequences.

Derivatives were created to soften — or in the argot of Wall Street, “hedge” — investment losses. For example, some of the contracts protect debt holders against losses on mortgage securities. (Their name comes from the fact that their value “derives” from underlying assets like stocks, bonds and commodities.) Many individuals own a common derivative: the insurance contract on their homes.

On a grander scale, such contracts allow financial services firms and corporations to take more complex risks that they might otherwise avoid — for example, issuing more mortgages or corporate debt. And the contracts can be traded, further limiting risk but also increasing the number of parties exposed if problems occur.

Throughout the 1990s, some argued that derivatives had become so vast, intertwined and inscrutable that they required federal oversight to protect the financial system. In meetings with federal officials, celebrated appearances on Capitol Hill and heavily attended speeches, Mr. Greenspan banked on the good will of Wall Street to self-regulate as he fended off restrictions.

Ever since housing began to collapse, Mr. Greenspan’s record has been up for revision. Economists from across the ideological spectrum have criticized his decision to let the nation’s real estate market continue to boom with cheap credit, courtesy of low interest rates, rather than snuffing out price increases with higher rates. Others have criticized Mr. Greenspan for not disciplining institutions that lent indiscriminately.

But whatever history ends up saying about those decisions, Mr. Greenspan’s legacy may ultimately rest on a more deeply embedded and much less scrutinized phenomenon: the spectacular boom and calamitous bust in derivatives trading.

Faith in the System

Some analysts say it is unfair to blame Mr. Greenspan because the crisis is so sprawling. “The notion that Greenspan could have generated a totally different outcome is so naive,” said Robert E. Hall, an economist at the conservative Hoover Institution, a research group at Stanford.

Mr. Greenspan declined requests for an interview. His spokeswoman referred questions about his record to his memoir, “The Age of Turbulence,” in which he wrote:

“It seems superfluous to constrain trading in some of the newer derivatives and other innovative financial contracts of the past decade,” Mr. Greenspan writes. “The worst have failed; investors no longer fund them and are not likely to in the future.”

In his Georgetown speech, he entertained no talk of regulation, describing the financial turmoil as the failure of Wall Street to behave honorably.

“In a market system based on trust, reputation has a significant economic value,” Mr. Greenspan told the audience. “I am therefore distressed at how far we have let concerns for reputation slip in recent years.”

As the long-serving chairman of the Fed, the nation’s most powerful economic policy maker, Mr. Greenspan preached the transcendent, wealth-creating powers of the market.

A professed libertarian, he counted among his formative influences the novelist Ayn Rand, who portrayed collective power as an evil force set against the enlightened self-interest of individuals. In turn, he showed a resolute faith that those participating in financial markets would act responsibly.

An examination of more than two decades of Mr. Greenspan’s record on financial regulation and derivatives in particular reveals the degree to which he tethered the health of the nation’s economy to that faith.

As the nascent derivatives market took hold in the early 1990s, and in subsequent years, critics denounced an absence of rules forcing institutions to disclose their positions and set aside funds as a reserve against bad bets.

Time and again, Mr. Greenspan — a revered figure affectionately nicked named the Oracle — proclaimed that risks could be handled by the markets themselves.

“Proposals to bring even minimalist regulation were basically rebuffed by Greenspan and various people in the Treasury,” recalled Alan S. Blinder, a former Federal Reserve board member and an economist at Princeton University. “I think of him as consistently cheerleading on derivatives.”

Arthur Levitt Jr., a former chairman of the Securities and Exchange Commission, says Mr. Greenspan opposes regulating derivatives because of a fundamental disdain for government.

Mr. Levitt said that Mr. Greenspan’s authority and grasp of global finance consistently persuaded less financially sophisticated lawmakers to follow his lead.

“I always felt that the titans of our legislature didn’t want to reveal their own inability to understand some of the concepts that Mr. Greenspan was setting forth,” Mr. Levitt said. “I don’t recall anyone ever saying, ‘What do you mean by that, Alan?’”

Still, over a long stretch of time, some did pose questions. In 1992, Edward J. Markey, a Democrat from Massachusetts, who led the House subcommittee on telecommunications and finance, asked what was then the General Accounting Office to study derivatives risks.

Two years later, the office released its report, identifying “significant gaps and weaknesses” in the regulatory oversight of derivatives.

“The sudden failure or abrupt withdrawal from trading of any of these large U.S. dealers could cause liquidity problems in the markets and could also pose risks to others, including federally insured banks and the financial system as a whole,” Charles A. Bowsher, head of the accounting office, said when he testified before Mr. Markey’s committee in 1994. “In some cases intervention has and could result in a financial bail-out paid for or guaranteed by taxpayers.”

In his testimony at the time, Mr. Greenspan was reassuring. “Risks in financial markets, including derivatives markets, are being regulated by private parties,” he said.

“There is nothing involved in federal regulation per se which makes it superior to market regulation.”

Mr. Greenspan warned that derivatives could amplify crises because they tied together the fortunes of many seemingly independent institutions. “The very efficiency that is involved here means that if a crisis were to occur, that crisis is transmitted at a far faster pace and with some greater virulence,” he said.

But he called that possibility “extremely remote,” adding that “risk is part of life.”

Later that year, Mr. Markey introduced a bill requiring greater derivatives regulation. It never passed.

Resistance to Warnings

In 1997, the Commodity Futures Trading Commission, a federal agency that regulates options and futures trading,
began exploring derivatives regulation. The commission, then led by a lawyer named Brooksley E. Born, invited comments about how best to oversee certain derivatives.

Ms. Born was concerned that unfeathered, opaque trading could “threaten our regulated markets or, indeed, our economy without any federal agency knowing about it,” she said in Congressional testimony. She called for greater disclosure of trades and reserves to cushion against losses.

Ms. Born's views incited fierce opposition from Mr. Greenspan and Robert E. Rubin, the Treasury secretary. Treasury lawyers concluded that merely discussing new rules threatened the derivatives market. Mr. Greenspan warned that too many rules would damage Wall Street, prompting traders to take their business overseas.

Greenspan told Brooksley that she essentially didn’t know what she was doing and cause a financial crisis,” said Michael Greenberger, who was a senior director at the commission. Brooksley was this woman who was not playing tennis with these guys and not having lunch with these guys. There was a little bit of the feeling that this woman was not of Wall Street.”

Ms. Born declined to comment. Mr. Rubin, now a senior executive at the banking giant Citigroup, says that he favored regulating derivatives — particularly increasing potential loss reserves — but that he saw no way of doing so while he was running the Treasury.

“All of the forces in the system were arrayed against it,” he said. “The industry certainly didn’t want any increase in these requirements. There was no potential for mobilizing public opinion.”

Mr. Greenberger asserts that the political climate would have been different had Mr. Rubin called for regulation.

In early 1998, Mr. Rubin’s deputy, Lawrence H. Summers, called Ms. Born and chastised her for taking steps he said would lead to a financial crisis, according to Mr. Greenberger. Mr. Summers said he could not recall the conversation but agreed with Mr. Greenspan and Mr. Rubin that Ms. Born’s proposal was “highly problematic.”

On April 21, 1998, senior federal financial regulators convened in a wood-paneled conference room at the Treasury to discuss Ms. Born’s proposal. Mr. Rubin and Mr. Greenspan implored her to reconsider, according to both Mr. Greenberger and Mr. Levitt.

Ms. Born pushed ahead. On June 5, 1998, Mr. Greenspan, Mr. Rubin and Mr. Levitt called Mr. Greenspan to Congress to press Ms. Born from acting until more senior regulators developed their own recommendations. Mr. Levitt says he now regrets that decision. Mr. Greenspan and Mr. Rubin were “joined at the hip on this,” he said. “They were certainly very fiercely opposed to this and persuaded me that this would cause cha-

Ms. Born soon gained a potent example. In the fall of 1998, the hedge fund Long Term Capital Management nearly collapsed, dragged down by disastrous bets on, among other things, derivatives. More than a dozen banks pooled $3.6 billion for a private rescue to prevent the fund from slipping into bankruptcy and endangering other firms.

Despite that event, Congress froze the Commodity Futures Trading Commission’s regulatory authority for six months. The following year, Ms. Born departed.

In November 1999, senior regulators — including Mr. Greenspan and Mr. Rubin — recommended that Congress permanently strip the C.F.T.C. of regulatory authority over derivatives. Mr. Greenspan, according to lawmakers, then used his prestige to make sure Congress followed through. “Alan was held in very high regard,” said Jim Leach, an Iowa Republican who led the House Banking and Financial Services Committee at the time. “You’ve got an area of judgment in which members of Congress have needed expertise.”

As the stock market roared forward on the heels of a historic bull market, the dominant view was that the good times largely stemmed from Mr. Greenspan’s steady hand at the Fed.

“You will go down as the greatest chairman in the history of the Federal Reserve Bank,” declared Senator Phil Gramm, the Texas Republican who was chairman of the Senate Banking Committee when Mr. Greenspan appeared there in February 1999.

Mr. Greenspan’s credentials and confidence reinforced his reputation — helping him to persuade Congress to repeal Depression-era laws that separated commercial and investment banking in order to reduce overall risk in the financial system.

“He had a way of speaking that made you think he knew exactly what he was talking about at all times,” said Senator Tom Harkin, a Democrat from Iowa. “He was able to say things in a way that made people not want to question him on anything, like he knew it all. He was the Oracle, and who were you to question him?”

In 2000, Mr. Harkin asked what might happen if Congress weakened the C.F.T.C.’s authority.

“If you have this exclusion and something unforeseen happens, who does something about it?” he asked Mr. Greenspan in a hearing.

Mr. Greenspan said that Wall Street could be trusted. “There is a very fundamental trade-off of what type of economy you wish to have,” he said. “You can have huge amounts of regulation and I will guarantee nothing will go wrong, but nothing will go right either,” he said.

Later that year, at a Congressional hearing on the merger boom, he argued that Wall Street had tamed risk.

“Aren’t you concerned with such a growing concentration of wealth that if one of these huge institutions fails that it will have a horrendous impact on the national and global economy?” asked Representative Bernard Sanders, an independent from Vermont.

“No, I’m not,” Mr. Greenspan replied. “I believe that the general growth in large institutions have occurred in the context of an underlying structure of markets in which many of the larger risks are dramatically — I should say, fully — hedged.”

The House overwhelmingly passed the bill that kept derivatives clear of F.T.C. oversight. Senate Democrats attached a rider limiting the C.F.T.C.’s authority to an 11,000-page appropriations bill. The Senate passed it. President Clinton signed it into law.

Pressing Forward

Still, savvy investors like Mr. Buffett continued to raise alarms about derivatives, as he did in 2003, in his annual letter to shareholders of his company, Berkshire Hathaway.

“Large amounts of risk, particularly credit risk, have become concentrated in the hands of relatively few derivatives dealers,” he wrote. “The troubles of one could quickly infect the others.”

But business continued.

And when Mr. Greenspan began to hear of a housing bubble, he dismissed the threat. Wall Street was using derivatives, he said in a 2004 speech, to share risks with other firms.

Shared risk has since evolved from a source of comfort into a virus. As the housing crisis grew and mortgages went bad, derivatives actually magnified the downturn.

The Wall Street debacle that swallowed firms like Bear Stearns and Lehman Brothers, and imperiled the insurance giant American International Group, has been driven by the fact that they and their customers were linked to one another by derivatives.

In recent months, as the financial crisis has gathered momentum, Mr. Greenspan’s public appearances have become less frequent.

His memoir was released in the middle of 2007, as the disaster was unfolding, and his book tour suddenly became a referendum on his policies. When the paperback version came out this year, Mr. Greenspan wrote an epilogue that offers a rebuttal of sorts.

“Risk management can never achieve perfection,” he wrote. The villains, he wrote, were the bankers whose self-interest he had once bet upon.

“They gambled that they could keep adding to their risky positions and still sell them out before the deluge,” he wrote. “Most were wrong.”

No federal intervention was marshaled to try to stop them, but Mr. Greenspan has no regrets.

“Governments and central banks,” he wrote, “could not have altered the course of the boom.”
A LINGERING GLOBAL INFLUENCE An interview with Alan Greenspan, nicknamed the Oracle, was shown live outside the Bombay Stock Exchange last month.


Growth of a Complex Market
The market for financial instruments known as derivatives — contracts intended to hedge against risk whose values are derived from underlying assets — has increased fivefold since 2002. While Alan M. Greenspan was a champion of them and opposed regulating them, others warned of their risk.

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<th>Derivatives outstanding</th>
<th>2002 total</th>
<th>2008 total</th>
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<td>Notional value, or the amount of the underlying asset on which they are based</td>
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<td>Interest rate swaps and options, currency swaps</td>
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<td>Equity derivatives</td>
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<td>Credit default swaps</td>
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2002 total $106.8 trillion

2008 total $531.2 trillion

$464.7

$11.9

$54.6

Source: International Swaps and Derivatives Association
Mr. Greenspan and Mr. Rubin — recommended that Congress permanently strip the C.F.T.C. of regulatory authority over derivatives. Then used his prestige to make sure Congress followed through. “Alan was held in very high regard,” said Jim Leach, an Iowa Republican who led the hearing on the merger boom, he argued "Aren’t you concerned with such a growing concentration of wealth that if something about it?” he asked Mr. Greenspan in a hearing.

In 2000, Mr. Harkin asked what might C.F.T.C.’s authority. He had a way of speaking that made the bill that kept derivatives clear of regulation per se which makes it superior. In his testimony at the time, Mr. Greenspan warned that derivatives market. Mr. Greenspan warned that derivatives were created to soften — the worst have failed; investors no longer fund them and are not likely to in the future.

There is nothing involved in federal regulation per se which makes it superior. Mr. Greenspan warned that derivatives were created to soften — decreasing the number of parties exposed to their homes. Wall Street was using derivatives, he said in a 2004 speech, to share risks with other firms. A professed libertarian, he counted Ayn Rand, who portrayed collectivist instead have stoked uncertainty and actually spread risk amid doubts about how companies value them. The House overwhelmingly passed measures to keep derivatives clear of regulation. But business continued. And when Mr. Greenspan began to entertain no talk of regulation, describing the financial turmoil as the failure of Wall Street to behave honorably.

In his Georgetown speech, he entertained no talk of regulation, describing the financial turmoil as the failure of Wall Street to behave honorably. Risk management can never be governed by government. The worst have failed; investors no longer fund them and are not likely to in the future. The bill that kept derivatives clear of regulation never passed. But business continued.

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Risk management can never be governed by government. The worst have failed; investors no longer fund them and are not likely to in the future.
Citigroup Pays for a Rush to Risk

Bank Saw No Red Flags Even as It Made Bolder Bets

“Our job is to set a tone at the top to incent people to do the right thing and to set up safety nets to catch people who make mistakes or do the wrong thing and correct those as quickly as possible. And it is working. It is working.”

Charles O. Prince III, Citigroup’s chief executive, in 2006

By ERIC DASH
and JULIE CRESWELL

In September 2007, with Wall Street confronting a crisis caused by too many souring mortgages, Citigroup executives gathered in a wood-paneled library to assess their own well-being.

There, Citigroup’s chief executive, Charles O. Prince III, learned for the first time that the bank owned about $43 billion in mortgage-related assets. He asked Thomas G. Maheras, who oversaw trading at the bank, whether everything was O.K.

Mr. Maheras told his boss that no big losses were looming, according to people briefed on the meeting who would speak only on the condition that they not be named.

For months, Mr. Maheras’s reassurances to others at Citigroup had quieted internal concerns about the bank’s vulnerability. But this time, a risk-management team was dispatched to more rigorously examine Citigroup’s huge mortgage-related holdings. They were too late, however: within several weeks, Citigroup would announce billions of dollars in losses.

Normally, a big bank would never allow the word of just one executive to carry so much weight. Instead, it would have its risk managers aggressively look over any shoulder and guard against trading or lending excesses.

But many Citigroup insiders say the bank’s risk managers never investigated deeply enough. Because of longstanding ties that clouded their judgment, the very people charged with overseeing deal makers eager to increase short-term earnings — and executives’ multimillion-dollar bonuses — failed to rein them in, these insiders say.

Today, Citigroup, once the nation’s largest and mightiest financial institution, has been brought to its knees by more than $65 billion in losses, writedowns for troubled assets and charges to account for future losses. More than half of that amount stems from mortgage-related securities created by Mr. Maheras’s team — the same products Mr. Prince was

Continued on Page 34
briefed on during that 2007 meeting.

Citigroup's stock has plummeted to its lowest price in more than a decade, closing Friday at $3.77. At that price the company is worth just $20.5 billion, down from $244 billion two years ago. Waves of layoffs have accompanied that slide, with about 75,000 jobs already gone or set to disappear from a work force that numbered about 375,000 a year ago.

Burdened by the losses and a crisis of confidence, Citigroup's future is so uncertain that regulators in New York and Washington held a series of emergency meetings late last week to discuss ways to help the bank right itself.

And as the credit crisis appears to be entering another treacherous phase despite a $780 billion federal bailout, Citigroup's woes are emblematic of the haphazard management and rush to riches that enveloped all of Wall Street. All across the banking business, easy profits and a booming housing market led many prominent financiers to overlook the dangers they courted.

While much of the damage inflicted on Citigroup and the broader economy was caused by errant, high-octane trading and lax oversight, critics say, blame also reaches into the highest levels at the bank. Earlier this year, the Federal Reserve took the bank to task for poor oversight and risk controls in a report it sent to Citigroup.

The bank’s downfall was years in the making and involved many in its hierarchy, particularly Mr. Prince and Robert E. Rubin, an influential director and senior adviser.

Citigroup insiders and analysts say that Mr. Prince and Mr. Rubin played pivotal roles in the bank's current woes, by drafting and blessing a strategy that involved taking greater trading risks to expand its business and reap higher profits. Mr. Prince and Mr. Rubin both declined to comment for this article.

When he was Treasury secretary during the Clinton administration, Mr. Rubin helped loosen Depression-era banking regulations that made the creation of Citigroup possible by allowing banks to expand far beyond their traditional role as lenders and permitting them to profit from a variety of financial activities. During the same period he helped beat back tighter oversight of exotic financial products, a development he had previously said he was helpless to prevent.

And since joining Citigroup in 1999 as a trusted adviser to the bank’s senior executives, Mr. Rubin, who is an economic adviser on the transition team of President-elect Barack Obama, has sat atop a bank that has been roiled by one financial miscreant after another.

Citigroup was ensnared in murky financial dealings with the defunct energy company Enron, which drew the attention of federal investigators; it was criticized by law enforcement officials for the role one of its prominent research analysts played during the telecom bubble several years ago; and it found itself in the middle of regulatory violations in Britain and Japan.

For a time, Citigroup’s megabank model paid off handsomely, as it rang up billions in earnings each quarter from mortgage-related securities, it courted disaster. As it built up that business, it used accounting maneuvers to move billions of dollars of the troubled assets off its books, freeing capital so the bank could grow even larger. Because of pending accounting changes, Citigroup and other banks have been bringing those assets back in-house, raising concerns about a new round of potential losses.

To some, the misery at Citigroup is no surprise. Lynn Turner, a former chief accountant with the Securities and Exchange Commission, said the bank’s balkanized culture and pell-mell management made problems inevitable.

“If you’re an entity of this size,” he said, “if you don’t have controls, if you don’t have the right culture and you don’t have people accountable for the risks that they are taking, you’re Citigroup.”

Questions on Oversight

Though they carry less prestige and are paid less than Wall Street traders and bankers, risk managers can wield significant clout. Their job is to monitor trading floors and inquire about how a bank’s money is being invested, so they can head off potential problems before blow-ups occur. Though risk managers and traders work side by side, they can have an uncomfortable coexistence because the monitors can put a brake on trading.

That is the way it works in theory. But at Citigroup, many say, it was a bit different.

David C. Bushnell was the senior risk officer who, with help from his staff, was supposed to keep an eye on the bank’s bond trading business and its multi-billion-dollar portfolio of mortgage-backed securities. Those activities were part of what the bank called its fixed-income business, which Mr. Maheras supervised.

One of Mr. Maheras’s trusted deputies, Randolph H. Barker, helped oversee the huge build-up in mortgage-related securities at Citigroup. But Mr. Bushnell, Mr. Maheras and Mr. Barker were all old friends, having climbed the bank’s corporate ladder together.

It was common in the bank to see Mr. Bushnell waiting patiently — sometimes as long as 45 minutes — outside Mr. Barker’s office so he could drive him home to Short Hills, N.J., where both of their families lived. The two men took occasional fly-fishing trips together; one expedition left them stuck on a lake after their boat ran out of gas.

Because Mr. Bushnell had to monitor traders working for Mr. Barker’s bond desk, their friendship raised eyebrows inside the company among those concerned about its controls.

David Bushnell was a risk officer for bond trading.
ment.

For some time after Sanford I. Weill, an architect of the merger that created Citigroup a decade ago, took control of Citigroup, he toned down the bank's bond trading. But in late 2002, Mr. Prince, who had been Mr. Weill's longtime legal counsel, was put in charge of Citigroup's corporate and investment bank.

According to a former Citigroup executive, Mr. Prince started putting pressure on Mr. Maheras and others to increase earnings in the bank's trading operations, particularly in the creation of collateralized debt obligations, or C.D.O.'s — securities that packaged mortgages and other forms of debt into bundles for resale to investors.

Because C.D.O.'s included so many forms of bundled debt, gauging their risk was particularly tricky; some parts of the bundle could be sound, while others were vulnerable to default.

"Chuck Prince going down to the corporate investment bank in late 2002 was the start of that process," a former Citigroup executive said of the bank's big C.D.O. push. "Chuck was totally new to the job. He didn't know a C.D.O. from a grocery list, so he looked for someone for advice and support. That person was Rubin. And Rubin had always been an advocate of being more aggressive in the capital markets arena. He would say, 'You have to take more risk if you want to earn more.'"

It appeared to be a good time for building up Citigroup's C.D.O. business. As the housing market around the country took flight, the C.D.O. market also grew apace as more and more mortgages were pooled together into new-fangled securities.

From 2003 to 2005, Citigroup more than tripled its issuance of C.D.O.'s, to more than $20 billion from $6.28 billion, and Mr. Maheras, Mr. Barker and others on the C.D.O. team helped transform Citigroup into one of the industry's biggest players. Firms issuing the C.D.O.'s generated fees of 0.4 percent to 2.5 percent of the amount sold — meaning Citigroup made up to $500 million in fees from the business in 2005 alone.

Even as Citigroup's C.D.O. stake was expanding, its top executives wanted more profits from that business. Yet they were not running a bank that was up to all the challenges it faced, including properly overseeing billions of dollars' worth of exotic products, according to Citigroup insiders and regulators who later criticized the bank.

When Mr. Prince was put in charge in 2003, he presided over a mess of warring business units and operational holes, particularly in critical areas like risk-management and controls.

"He inherited a gobbledygook of companies that were never integrated, and it was never a priority of the company to invest," said Meredith A. Whitney, a banking analyst who was one of the company's early critics. "The business-es didn't communicate with each other. There were dozens of technology systems and dozens of financial ledgers."

Problems with trading and banking oversight at Citigroup became so dire that the Federal Reserve took the unusual step of telling the bank it could make no more acquisitions until it put its house in order.

In 2005, stung by regulatory rebukes and unable to follow Mr. Weill's penchant for expanding Citigroup's holdings through rapid-fire takeovers, Mr. Prince and his board of directors decided to push even more aggressively into trading and other business that would allow Citigroup to continue expanding the bank internally.

One person who helped push Citigroup along this new path was Mr. Rubin.

Pushing Growth

Robert Rubin has moved seamlessly between Wall Street and Washington. After making his millions as a trader and an executive at Goldman Sachs, he joined the Clinton administration. Mr. Weill, as Citigroup's chief, wooed Mr. Rubin to join the bank after Mr. Rubin left Washington. Mr. Weill had been involved in the financial services industry's lobbying to persuade Washington to loosen its regulatory hold on Wall Street.

As chairman of Citigroup's executive committee, Mr. Rubin was the bank's resident sage, advising top executives and serving on the board while, he insisted repeatedly, steering clear of daily management issues.

"By the time I finished at Treasury, I decided I never wanted operating responsibility again," he said in an interview in April. Asked then whether he had made any mistakes during his tenure at Citigroup, he offered a tentative response.

"I've thought a lot about that," he said. "I honestly don't know. In hindsight, there are a lot of things we'd do differently. But in the context of the facts as I knew them and my role, I'm inclined to think probably not."

Besides, he said, it was impossible to get a complete handle on Citigroup's vulnerabilities unless you dealt with the trades daily.

"There is no way you would know what was going on with a risk book unless you're directly involved with the trading arena," he said. "We had highly experienced, highly qualified people running the operation."

But while Mr. Rubin certainly did not have direct responsibility for a Citigroup unit, he was an architect of the bank's strategy.

In 2005, as Citigroup began its effort to expand from within, Mr. Rubin peppered his colleagues with questions as they formulated the plan. According to current and former colleagues, he believed that Citigroup was falling behind rivals like Morgan Stanley and Goldman, and he pushed to bulk up the bank's high-growth fixed-income trading, including the C.D.O. business.

Former colleagues said Mr. Rubin also encouraged Mr. Prince to broaden the bank's appetite for risk, provided that it also upgraded oversight —

PLAYING DOWN CONCERNS

Thomas Maheras concerns the bank's trading division.

though the Federal Reserve later would conclude that the bank's oversight remained inadequate.

Once the strategy was outlined, Mr. Rubin helped Mr. Prince gain the board's confidence that it would work.

After that, the bank moved even more aggressively into C.D.O.'s. It added to its trading operations and snagged crucial people from competitors. Bonuses doubled and tripled for C.D.O. traders. Mr. Barker drew pay totaling $15 million to $20 million a year, according to former colleagues, and Mr. Maheras became one of Citigroup's most highly compensated employees, earning as much as $30 million at the peak — far more than top executives like Mr. Bushnell in the risk-management department.

In December 2005, with Citigroup divi-
stance, risk managers in the fixed-income division reported to both Mr. Maheras and Mr. Bushnell — setting up a potential conflict because that gave Mr. Maheras influence over employees who were supposed to keep an eye on his traders.

C.D.O.’s were complex, and even experienced managers like Mr. Maheras and Mr. Barker underestimated the risks they posed, according to people with direct knowledge of Citigroup’s business. Because of that, they put blind faith in the passing grades that major credit-rating agencies bestowed on the debt.

While the sheer size of Citigroup’s C.D.O. position caused concern among some around the trading desk, most say they kept their concerns to themselves. “I just think senior managers got addicted to the revenues and arrogant about the risks they were running,” said one person who worked in the C.D.O. group. “As long as you could grow revenues, you could keep your bonus growing.”

To make matters worse, Citigroup’s risk models never accounted for the possibility of a national housing downturn, this person said, and the prospect that millions of homeowners could default on their mortgages. Such a downturn did come, of course, with disastrous consequences for Citigroup and its rivals on Wall Street.

Even as the first shock waves of the subprime mortgage crisis hit Bear Stearns in June 2007, Citigroup’s top executives expressed few concerns about their bank’s exposure to mortgage-linked securities.

In fact, when examiners from the Securities and Exchange Commission began scrutinizing Citigroup’s subprime mortgage holdings after Bear Stearns’s problems surfaced, the bank told them that the probability of those mortgages defaulting was so tiny that they excluded them from their risk analysis, according to a person briefed on the discussion who would speak only without being named.

Later that summer, when the credit markets began seizing up and values of various C.D.O.’s began to plummet, Mr. Maheras, Mr. Barker and Mr. Bushnell participated in a meeting to review Citigroup’s exposure.

The size of mortgage-related securities held by Citigroup was “viewed by the rating agencies to have an extremely low probability of default (less than 0.01%),” according to Citigroup slides used at the meeting and reviewed by The New York Times.

Around the same time, Mr. Maheras continued to assure his colleagues that the bank “would never lose a penny,” according to an executive who spoke to him.

In mid-September 2007, Mr. Prince convened the meeting in the small library outside his office to gauge Citigroup’s exposure.

Mr. Maheras assured the group, which included Mr. Rubin and Mr. Bushnell, that Citigroup’s C.D.O. position was safe. Mr. Prince had never questioned the ballooning portfolio before this because no one, including Mr. Maheras and Mr. Bushnell, had warned him.

But as the subprime market plunged further, Citigroup’s position became more dire — even though the firm held onto the belief that its C.D.O.’s were safe.

On Oct. 1, it warned investors that it would write off $1.3 billion in subprime mortgage-related assets. But of the $43 billion in C.D.O.’s it had on its books, it wrote off only about $95 million, according to a person briefed on the situation.

Soon, however, C.D.O. prices began to collapse. Credit-rating agencies downgraded C.D.O.’s, threatening Citigroup’s stock price. A week later, Mr. Prince aggressively marked down similar securities, forcing other banks to face reality.

By early November, Citigroup’s anticipated write-downs ballooned to $8 billion to $11 billion. Mr. Barker and Mr. Maheras lost their jobs, as Mr. Bushnell did later on. And on Nov. 4, Mr. Prince told the board that he, too, would resign.

Although Mr. Prince received no severance, he walked away with Citigroup stock valued then at $68 million — along with a cash bonus of about $12.5 million for 2007.

Putting Out Fires

Mr. Prince was replaced last December by Vikram S. Pandit, a former money manager and investment banker whom Mr. Rubin had earlier recruited in a senior role. Since becoming chief executive, Mr. Pandit has been scrambling to put out fires and repair Citigroup’s deficient risk-management systems.

Earlier this year, Federal Reserve examiners quietly presented the bank with a scathing review of its risk-management practices, according to people briefed on the situation.

Citigroup executives responded with a 25-page single-spaced memo outlining a sweeping overhaul of the bank’s risk management.

In May, Brian Leach, Citigroup’s new chief risk officer, told analysts that his bank had greatly improved oversight and installed several new risk managers. He said he wanted to ensure “that Citi takes the lessons learned from recent events and makes critical enhancements to its risk management framework. A change in culture is required at Citi.”

Meanwhile, regulators have criticized the banking industry as a whole for relying on outsiders — in particular the ratings agencies — to help them gauge the risk of their investments.

“There is really no excuse for institutions that specialize in credit risk assessment, like large commercial banks, to rely solely on credit ratings in assessing credit risk,” John C. Dugan, the head of the Office of the Comptroller of the Currency, the chief federal bank regulator, said in a speech earlier this year.

But he noted that what caused the largest problem for some banks was that they retained dangerously big positions in certain securities — like C.D.O.’s — rather than selling them off to other investors.

“How most differentiated the companies sustaining the biggest losses from the rest was their willingness to hold exceptionally large positions on their balance sheets which, in turn, led to exceptionally large losses,” he said.

Mr. Dugan did not mention any specific bank by name, but Citigroup is the largest player in the C.D.O. business of any bank the comptroller regulates.

For his part, Mr. Pandit faces the twin challenge of rebuilding investor confidence while trying to fix the company’s myriad problems.

Citigroup has suffered four consecutive quarters of multibillion-dollar losses as it has written down billions of dollars of the mortgage-related assets it held on its books.

But investors worry there is still more to come, and some board members have raised doubts about Mr. Pandit’s leadership, according to people briefed on the situation.

Citigroup still holds $20 billion of mortgage-linked securities on its books, the bulk of which have been marked down to between 21 cents and 41 cents on the dollar. It has billions of dollars of giant buyout and corporate loans. And it also faces a potential flood of losses on auto, mortgage and credit card loans as the global economy plunges into a recession.

Also, hundreds of billions of dollars in dubious assets that Citigroup held off its balance sheet is now starting to be moved back onto its books, setting off yet another potential problem.

The bank has already put more than $55 billion in assets back on its balance sheet. It now says an added $122 billion of assets related to credit cards and possibly billions of dollars of other assets will probably come back on the books.

Even though Citigroup executives insist that the bank can ride out its current difficulties, and that the repatriated assets pose no threat, investors have their doubts. Because analysts do not have a complete grip on the quality of those assets, they are warning that Citigroup may have to set aside billions of dollars to guard against losses.

In fact, some analysts say they believe that the $25 billion that the federal government invested in Citigroup this fall might not be enough to stabilize it.

Others say the fact that such huge amounts have yet to steady the bank is a reflection of the severe damage caused by Citigroup’s appetites.
“They pushed to get earnings, but in doing so, they took on more risk than they probably should have if they are going to be, in the end, a bank subject to regulatory controls,” said Roy Smith, a professor at the Stern School of Business at New York University. “Safe and soundness has to be no less important than growth and profits but that was subordinated by these guys.”
Citigroup’s Exotic Investments

Because Citigroup bundled mortgages and many other types of debt into collateralized debt obligations, or C.D.O.’s, it made risk hard to gauge.

C.D.O.’S ISSUED

World total

Citigroup

CITIGROUP’S RANK, by total value of C.D.O.’s issued

Source: Thomson Reuters
Citigroup's future is so uncertain that regulators in New York and Washington held a series of emergency meetings. Citigroup insiders and analysts say that when Mr. Rubin took over the bank, he created a haphazard management and rush to expand far beyond its traditional role as lenders and permitting them to profit from a variety of financial products.

Mr. Barker drew pay totaling $15 million for resale to investors. Because C.D.O.'s included so many bundles for resale, one of Citigroup's most highly compensated employees, earning as much as $30 million at the peak — far more than top executives like Mr. Bushnell in the risk-management department.

In December 2005, with Citigroup diversifying, its risk controls fell further. One of Mr. Maheras's trusted deputies, Randolph H. Barker, helped oversite the huge build-up in mortgage-related securities at Citigroup. But Mr. Bushnell, Mr. Maheras and Mr. Barker were all old friends, having climbed the corporate ladder in the bank.

To some, the misery at Citigroup is no surprise. At the beginning of 2006, during a meeting with senior adviser and underwriter, Mr. Barker, Mr. Maheras and Mr. Bushnell discussed a plan to keep their traders or bankers wanted to complete a potentially profitable deal, they could sometimes rely on Mr. Barker to come up with a risk book unless you're directly involved with the trade, said a former Citigroup executive.

It was common in the bank to see Mr. Bushnell, Mr. Maheras and Mr. Barker. They didn't communicate with each other. There were dozens of technology systems and dozens of financial ledgers. As long as you could grow revenues, you could keep your bonus growing.

Risk management "has to be independent of the business units," a trusted adviser to the bank's senior executives, Mr. Rubin, who is an economic adviser on the transition team of President-elect Barack Obama, has sat at top a bank that has been roiled by one financial miscue after another.

According to a former Citigroup executive, Mr. Rubin, who joined the bank after Mr. Prince, who had been Mr. Weill's long-time J.P. Morgan chief, and Mr. Maheras, who was an architect of the merger that created Citigroup, at least when it came to fixed income, was an architect of the bank's strategy.

"He inherited a gobbledygook of companies that were never integrated, and experienced, highly qualified people running the operation," Mr. Rubin said. "I've thought a lot about that," he said in an interview, "when I look back, I just can't believe how much they didn't communicate with each other.

In 2005, stung by regulatory rebukes involving Mr. Bushnell and Mr. Barker, people inside the bank say. One person who helped push Citigroup into one of the industry's biggest leveraged-finance deals, including the C.D.O. business. Mr. Barker was a trusted adviser to the bank's senior executives, Mr. Rubin, who is an economic adviser on the transition team of President-elect Barack Obama, has sat at top a bank that has been roiled by one financial miscue after another.

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From Midwest to M.T.A.,
Pain From Global Gamble

“People come up to me in the grocery store and say, ‘How did we get suckered into this?’”

— Marc Hujik, of the Kenosha, Wis., school board

By CHARLES DUHIGG and CARTER DOUGHERTY

On a snowy day two years ago, the school board in Whitefish Bay, Wis., gathered to discuss a looming problem: how to plug a gaping hole in the teachers’ retirement plan.

It turned to David W. Noack, a trusted local investment banker, who proposed that the district borrow from overseas and use the money for a complex investment that offered big profits.

“Every three months you’re going to get a payment,” he promised, according to a tape of the meeting. But would it be risky? “There

THE RECKONING
Perilous Connections

would need to be 15 Enrons” for the district to lose money, he said.

The board and four other nearby districts ultimately invested $200 million in the deal, most of it borrowed from an Irish bank. Without realizing it, the schools were imitating hedge funds.

Half a continent away, New York subway officials were also being wooed by bankers. Officials were told that just as home buyers had embraced adjustable-rate loans, New York could save money by borrowing at lower interest rates that changed every day.

For some of the deals, the officials were encouraged to rely on the same Irish bank as the Wisconsin schools.

During the go-go investing years, school districts, transit agencies and other government entities were quick to jump into the global economy, hoping for fast gains to cover growing pension costs and budgets without raising taxes. Deals were arranged by armies of persuasive financiers who received big paydays.

But now, hundreds of cities and government agencies are facing economic turmoil. Far from being isolated examples, the Wisconsin schools and New York’s transportation system are among the many players in a financial fiasco that has ricocheted globally.

The Wisconsin schools are on the brink of losing their money, confronting educators with possible budget cuts. Interest rates for New York’s subways are skyrocketing and contributing to budget woes that have transportation officials considering higher fares and delaying long-planned track repairs.

And the bank at the center of the saga, named Depfa, is now in trouble, threatening the stability of its parent company in Munich and forcing German officials to intervene with a multibillion-dollar bailout to stop a chain reaction that could freeze Germany’s economic system.

“I am really worried,” said Becky Velvikis, a first-grade teacher at Grewenow Ele-

Continued on Page 33
Selling Risk

Whitefish Bay’s school district did not intend to become a hedge fund. It and four nearby districts were just trying to finance retirement obligations that were growing as health care costs rose.

Mr. Noack, the local representative of Stifel Nicolaus & Company, a St. Louis investment bank, had been advising Wisconsin school boards for two decades, helping them borrow for new gymnasiums and classrooms. His father had taught at an area high school for 47 years. All six of his children attended Milwaukee schools.

Mr. Noack told the Whitefish Bay board that investing in the global economy carried few risks, according to the tape.

“What’s the best investment? It’s called a collateralized debt obligation,” or a C.D.O., Mr. Noack said. He described it as a collection of bonds from 105 of the most reputable companies that would pay the school board a small return every quarter.

“We’re being very conservative,” Mr. Noack told the board, composed of lawyers, salesmen and a homemaker who worked in the affluent Milwaukee suburb.

Soon, Whitefish Bay and the four other districts borrowed $165 million from Depfa and contributed $35 million of their own money to purchase three C.D.O.’s sold by the Royal Bank of Canada, which had a relationship with Mr. Noack’s company.

But Mr. Noack’s explanation of a C.D.O. was very wrong. Mr. Noack, who through his lawyer declined to comment, had attended only a two-hour training session on C.D.O.’s, he told a friend.

The schools’ $200 million was actually used as collateral for a complicated form of insurance guaranteeing about $200 million in plain vanilla bonds. That investment — known as a synthetic C.D.O. — committed the boards to paying off other bondholders if corpora-

tions failed to honor their debts.

If just 6 percent of the bonds insured went bad, the Wisconsin educators could lose all their money. If none of the bonds defaulted, the schools would receive about $1.8 million a year after paying off the $200 million. By comparison, the C.D.O.’s offered only a modestly better return than a $35 million investment in ultra-safe Treasury bonds, which would have paid about $1.5 million a year, with virtually no risk.

The boards, as part of their deal, received thick packets of documents. “I’ve never read the prospectus,” said Marc Hujik, a local financial adviser and a member of the Kenosha school board who spent 13 years on Wall Street. “We had all our questions answered satisfactorily by Dave Noack, so I wasn’t worried.”

Wisconsin schools were not the only ones to jump into such complicated financial products. More than $1.2 trillion of C.D.O.’s have been sold to buyers of all kinds since 2005 — including many cities and government agencies — an increase of 270 percent from the four previous years combined, according to Thomson Reuters.

“Selling these products to municipalities was pretty widespread,” said Janet Tavakoli, a finance industry consultant in Chicago. “They tend to be less sophisticated. So bankers sell them products stuffed with junk.”

From the Wisconsin deal, the Royal Bank of Canada received promises of payments totaling about $112 million, according to documents. Stifel Nicolaus made about $1.2 million. Mr. Noack’s total salary was about $300,000 a year, according to someone with knowledge of his finances. And Depfa received interest on its loans.

In separate statements, the Royal Bank of Canada and Stifel Nicolaus said board members signed documents indicating they understood the investments’ risks. Both companies said they were not financial advisers to the boards but merely sold them products or services. Stifel Nicolaus said its relationship with the boards ended in 2007. Mr. Noack now works for a rival firm.

“Everyone knew New York guys were making tons of money on these kinds of deals,” said Mr. Hujik, of the school board. “It wasn’t implausible that we could make money, too.”

A Bank Goes Global

By the time Depfa financed the Wisconsin schools’ investment, it had already become an emblem of the new global economy: It was founded 86 years ago as a sleepy German lender, and for most of its history had focused on its home market.

But in 2002 a new chief executive, Gerhard Bruckermann, moved Depfa to the freewheeling financial center of Dublin to take advantage of low corporate rates. He soon pushed the company into São Paulo, Mumbai, Warsaw, Hong Kong, Dallas, New York, Tokyo and elsewhere. Depfa became one of Europe’s most profitable banks and was famous for lavish events and large paychecks. In 2006, top executives took home the equivalent of $33 million at top exchange rates.

Mr. Bruckermann was a gregarious leader who joked that he hoped to make all employees into millionaires. He divided his time between a London home and a vast farm in Spain, where he grew exotic medicinal plants. And his success fueled an arrogance, former colleagues say.

Mr. Bruckermann once told a trade publication that Depfa, unlike German banks, understood how to benefit from the global economy. “With our efforts, we are like the one-eyed man who becomes king in the land of the blind,” he was quoted as saying.

Mr. Bruckermann, who left the bank earlier this year, did not respond to requests for an interview.

But as Depfa grew, other European banks began competing with the firm. So executives stretched into riskier deals — the sort that would eventually send shockwaves across Europe and the United States.

Some of Mr. Bruckermann’s employees grew concerned about deals like one struck in 2005 with the Metropolitan Transportation Authority of New York, the agency overseeing the city and suburban subways, buses and trains.

For years, municipal agencies like the M.T.A. had raised money by issuing plain-vanilla bonds with fixed interest rates. But then bankers began telling officials that there was a way to get cheaper financing.

Bankers said that cities, like home buyers, could save money with adjustable-rate loans, where the payments started low and changed over time. What they did not emphasize was that such payments could eventually skyrocket. Such borrowing — known as variable-rate bonds — also carried big fees for Wall Street.

The pitches were very successful. Municipalities issued twice as many variable-rate bonds last year as they did a decade earlier.

But variable-rate bonds had a hitch: many investors would purchase them only if a bank like Depfa was hired as a buyer of last resort, ready to acquire bonds from investors who could find no other buyers. Depfa collected fees for serving that role, but expected it would rarely have to honor such pledges.

Mr. Bruckermann’s salespeople traveled the world encouraging officials to sign up for variable-rate loans. And bureaucrats and politicians, including some in New York, jumped in.

By 2006 Depfa was the largest buyer of last resort in the world, standing behind $2.9 billion of bonds issued that year alone. It backed a $200 million bond issued by the M.T.A.
But as Depfa grew, it became more reliant on enormous short-term loans to finance its operations. Those loans cost less, and thus helped the bank achieve higher profits, but only when times were good. Indeed, some employees were worried about that debt.

But Mr. Bruckermann plowed ahead, and it paid off. In 2007, even as the global economy was softening, Mr. Bruckermann persuaded one of Germany’s biggest lenders, Hypo Real Estate, to purchase Depfa for $7.8 billion. Mr. Bruckermann’s cut was more than $150 million. He left the company to grow oranges on his Spanish estate.

The Risks Turn Bad

Last March the delicate web tying Wisconsin, Dublin and Manhattan became an anchor dragging everyone down.

Mr. Yde, the director of business services for the Whitefish Bay district, began receiving troubling messages indicating the district’s investments were declining. Worried, he started coming into his office at dawn, before the hallways of Whitefish Bay High School filled with students.

As the sun rose, Mr. Yde searched for explanations by the light of his computer screen. He Googled “C.D.O.’s.” He called bankers in London and New York. Each person referred him to someone else.

Then notices arrived saying that the bonds insured by Whitefish Bay’s C.D.O.’s were defaulting. It became increasingly likely that the district’s money would be seized to pay off other bondholders. Most, if not all, of the $200 million would probably be lost.

As other districts received similar notices, panic grew. For some boards, interest payments on borrowed money were now larger than revenue from the investments. Officials began quietly warning that they might have to dip into school funds.

“This is going to have a tremendous financial impact,” said Robert F. Kitchen, a member of the West Allis-West Milwaukee school board. Officials say some districts may have to cut courses like art and drama, curtail gym and classroom maintenance, or forgo replacing teachers who retire.

Problems were emerging elsewhere, as well.

Depfa’s executives were realizing that their loans to the Wisconsin schools were unlikely to be repaid. Additionally, bonds all over the world were declining in value, exposing the company to the possibility they would have to make good on their pledges as a buyer of last resort. And Depfa was still borrowing billions each month to cover its short-term loans. By autumn, the short-term debt of the bank and its parent company, Hypo, totaled $81 billion.

Then, in mid-September, the American investment bank Lehman Brothers went bankrupt. Short-term lending markets froze up. Ratings agencies, including Standard & Poor’s, downgraded Depfa, citing the company’s difficulties borrowing at affordable rates.

That set off a crisis in Germany, where officials worried that Depfa’s sudden need for cash would drag down its parent company and set off a chain reaction at other banks. The German government and private banks extended $64 billion in credit to Hypo to stop it from imploding.

“We will not allow the distress of one financial institution to endanger the entire system,” Angela Merkel, the German chancellor, said at the time.

That crisis spread almost immediately to the M.T.A.

The transportation authority, guided by Gary Dellaverson, a rumpled, cigarillo-smoking chief financial officer, had $3.75 billion of variable-rate debt outstanding.

About $200 million of that debt was backed by Depfa. When the bank was downgraded, investors dumped those transportation bonds, because of worries they would get stuck with them if Depfa’s problems worsened. Depfa was forced to buy $150 million of them, and bonds worth billions of dollars issued by other municipalities.

Then came the twist: Depfa’s contracts said that if it bought back bonds, the municipalities had to pay a higher-than-average interest rate. The New York transportation authority’s repayment obligation could eventually balloon by about $12 million a year on the Depfa loans alone.

On its own, that cost could be absorbed by the agency. But, as the economy declined, the M.T.A. had lost hundreds of millions because tax receipts — which finance part of its budget — were falling. And its ability to renew its variable-rate bonds at low interest rates was hurt by the trouble at Depfa and other banks. The transportation authority now faces a $900 million shortfall, according to officials. It is “fairly breathtaking,” Mr. Dellaverson told the M.T.A.’s finance committee. “This is not a tolerable long-term position for us to be in.”

In a recent interview, Mr. Dellaverson defended New York’s use of variable bonds.

“Variable-rate debt has helped M.T.A. save millions of dollars, and we’ve been conservative in issuing it,” he said. “But there are risks, which we work hard to mitigate. Usually it works. But what’s happening today is a total lack of marketplace rationality.”

In a statement, the transportation authority said that it was exploring options to reduce the cost of the Depfa-backed bonds, that its variable-rate bonds had delivered savings even during the current turmoil and that the agency had remained within its budget on debt payments this year.

However, the transportation authority has already announced it will raise subway and train fares next year because of various fiscal problems, and may be forced to shrink the work force and reduce some bus routes. Some analysts say fares will probably rise again in 2010.

The Depfa fallout doesn’t end there. Rating agencies have downgraded the bonds of more than 75 municipal agencies backed by Depfa, including in California, Connecticut, Illinois and South Dakota. Officials in Florida, Massachusetts and Montana have cut budgets because of C.D.O.’s or similar risky bets.

And Hypo, the German company that bought Depfa, last week asked the German government for financial help for the third time. Depfa has frozen much of its business, according to Wall Street bankers, and though it continues to honor its commitments, some wonder for how long.

The Wisconsin school districts have filed suit against the Royal Bank of Canada and Stifel Nicolaus alleging misrepresentations. Board members hope they will prevail and schools and retirement plans will emerge unscathed. The companies dispute the lawsuit’s claims. Mr. Noack is not named as a defendant and is cooperating with the school boards.

In Mrs. Velvikis’s classroom at Greenwood Elementary in Kenosha, students have recently completed a lesson in which each first grader contributed a vegetable to a common vat of “stone soup.” The project — based on a children’s book — teaches the benefits of working together. The schools have learned that when everyone works together, they can also eat! Starve.

“Our funding is already so limited,” Mrs. Velvikis said. “We rely on parent donations for some supplies. You hear about all these millions of dollars that have been lost, and you think, that’s got to come out of somewhere.”
All Connected: How a Crisis Spread Far and Wide

1. Wisconsin schools borrowed from an Irish bank to buy an investment managed by a Canadian bank.

2. But the investment was more complicated and risky than the schools realized.

3. Losses by the schools contributed to a financial crisis at the Irish bank and its German owner.

4. Troubles spread to local government investors with bonds guaranteed by the Irish bank.

In 2006, five Wisconsin school districts borrowed from Depfa Bank and invested in what they believed were high-grade bonds managed by the Royal Bank of Canada. The districts were hoping to bolster their retirement funds.

The schools’ money was actually used as insurance on $20 billion in corporate bonds – a promise to pay bondholders if corporations failed to pay their debts. The investment was registered in the Cayman Islands and managed by the Canadian bank, ACA and UBS.

The investment started going bad earlier this year, and the schools indicated they would likely not repay Depfa. That and other woes caused a crisis at the bank. Its parent, Hypo Real Estate, received a $75 billion bailout from Germany this fall.

Depfa had also guaranteed dozens of bonds issued by entities like the Metropolitan Transportation Authority in New York. As Depfa’s troubles mounted, those guarantees became more expensive. The agencies must pay penalties to Depfa.

THE NEW YORK TIMES
IN WISCONSIN “This is something I'll regret until the day I die,” said Shawn Yde of the Whitefish Bay schools.
White House Philosophy Stoked Mortgage Bonfire

“We can put light where there’s darkness, and hope where there’s despondency in this country. And part of it is working together as a nation to encourage folks to own their own home.” — President Bush, Oct. 15, 2002

This article is by Jo Becker, Sheryl Gay Stolberg and Stephen Labaton.

WASHINGTON — The global financial system was teetering on the edge of collapse when President Bush and his economics team huddled in the Roosevelt Room of the White House for a briefing that, in the words of one participant, “scared the hell out of everybody.”

It was Sept. 18. Lehman Brothers had just gone belly-up, overwhelmed by toxic mortgages. Bank of America had swallowed Merrill Lynch in a hastily arranged sale. Two days earlier, Mr. Bush had agreed to pump $85 billion into the failing insurance giant American International Group.

The president listened as Ben S. Bernanke, chairman of the Federal Reserve, laid out the latest terrifying news: The credit markets, gripped by panic, had frozen overnight, and banks were refusing to lend money.

Then his Treasury secretary, Henry M. Paulson Jr., told him that to stave off dis-

THE RECKONING
‘Ownership Society’

Homeownership rates hit historic highs during George W. Bush’s tenure but have since dropped to about where they were when he took office.

Source: U.S. Census Bureau

He himself said recently, “faced with the prospect of a global meltdown” with roots in the housing sector he so ardently champed.

There are plenty of culprits, like lenders who peddled easy credit, consumers who took on mortgages they could not afford and Wall Street chieftains who loaded up on mortgage-backed securities without regard to the risk.

But the story of how we got here is partly one of Mr. Bush’s own making, according to a review of his tenure that included interviews with dozens of current and former administration officials.

From his earliest days in office, Mr. Bush paired his belief that Americans do best when they own their own home with his conviction that markets do best when let alone.

He pushed hard to expand homeownership, especially among minorities, an initiative that dovetailed with his ambition to expand the Republican tent — and with the business interests of some of his biggest donors. But his housing policies and hands-off approach to regulation encouraged lax lending standards.

Mr. Bush did foresee the danger posed by Fannie Mae and Freddie Mac, the gov-

Continued on Page 36
ants. The president spent years pushing a recalcitrant Congress to toughen regulation of the companies, but was unwilling to compromise when his former Treasury secretary wanted to cut a deal. And the regulator Mr. Bush chose to oversee them — an old prep school buddy — pronounced the companies sound even as they headed toward insolvency.

As early as 2006, top advisers to Mr. Bush dismissed warnings from people inside and outside the White House that housing prices were inflated and that a foreclosure crisis was looming. And when the economy deteriorated, Mr. Bush and his aides were caught off guard by the reasons and scope of the downturn; as recently as February, for example, Mr. Bush was still calling it a “rough patch.”

The result was a series of piecemeal policy prescriptions that lagged behind the escalating crisis.

“There is no question we did not recognize the severity of the problems,” said A.J. Hubbard, Mr. Bush’s former chief economics adviser, who left the White House in December 2007. “Had we, we would have attacked them.”

Looking back, Keith B. Hennessey, Mr. Bush’s current chief economics adviser, says he and his colleagues did the best they could “with the information we had at the time.” But Mr. Hennessey did say he regretted that the administration did not pay more heed to the dangers of easy lending practices. And both Mr. Paulson and his predecessor, John W. Snow, say the housing push went too far.

“The Bush administration took a lot of pride that homeownership had reached historic highs,” Mr. Snow said in an interview. “But what we forgot in the process was that it has to be done in the context of people being able to afford their house. We now realize there was a high cost.”

For much of the Bush presidency, the White House was preoccupied by terrorism and war; on the economic front, its concerns were cutting taxes and privatizing Social Security. The housing market was a bright spot: ever-rising home values kept the economy humming, as owners drew down on their equity to buy consumer goods and pack their children off to college.

Lawrence B. Lindsay, Mr. Bush’s first chief economics adviser, said there was little impetus to raise alarms about the proliferation of easy credit that was helping Mr. Bush meet housing goals.

“No one wanted to stop that bubble,” Mr. Lindsay said. “It would have conflicted with the president’s own policies.”

Today, millions of Americans are facing foreclosure, homeownership rates are virtually as high as when Mr. Bush took office, Fannie and Freddie are in a government conservatorship, and the bailout cost to taxpayers could run in the trillions.

As the economy has shed jobs — 533,000 last month alone — and its party has been punished by irate voters, the weakened president has granted his Treasury secretary extraordinary leeway in managing the crisis.

Never once, Mr. Paulson said in a recent interview, has Mr. Bush overruled him. “I’ve got a boss,” he explained, who “understands that when you’re dealing with something as unprecedented and fast-moving as this we need to have a different operating style.”

Mr. Paulson and other senior advisers to Mr. Bush say the administration has responded well to the turmoil, demonstrating flexibility under difficult circumstances. “There is not any playbook,” Mr. Paulson said.

The president declined to be interviewed for this article. But in recent weeks Mr. Bush has shared his views of how the nation came to the brink of economic disaster. He cites corporate greed and market excesses fueled by a flood of foreign cash — “Wall Street got drunk,” he has said — and the policies of past administrations. He blames Congress for failing to reform Fannie and Freddie. Last week, Fox News asked Mr. Bush if he was worried about being the Herbert Hoover of the 21st century.

“No,” Mr. Bush replied. “I will be known as somebody who saw a problem and put the chips on the table to prevent the economy from collapsing.”

But in private moments, aides say, the president is looking inward. During a recent ride aboard Marine One, the presidential helicopter, Mr. Bush sounded a reflective note.

“We absolutely wanted to increase homeownership,” Tony Fratto, his deputy press secretary, recalled him saying, “But we never wanted lenders to make bad decisions.”

A Policy Gone Awry

Darrin West could not believe it. The president of the United States was standing in his living room.

It was June 17, 2002, a day Mr. West recalls as “the highlight of my life.” Mr. Bush, in Atlanta to unveil a plan to increase the number of minority homeowners by 5.5 million, was touring Park Place South, a development of starter homes in a neighborhood once marked by blight and crime.

Mr. West had patrolled there as a police officer, and now he was the proud owner of a $130,000 town house, bought with an adjustable-rate mortgage and a $20,000 government loan as his down payment — just the sort of creative public-private financing Mr. Bush was promoting.

“Part of economic security,” Mr. Bush declared that day, “is owning your own home.”

A lot has changed since then. Mr. West, beset by personal problems, left Atlanta. Unable to sell his home for what he owed, he said, he gave it back to the bank last year. Like other communities across America, Park Place South has been hit with a foreclosure crisis affecting at least 10 percent of its 232 homes, according to Masharn Wilson, a developer who led Mr. Bush’s tour.

“I just don’t think what he envisioned was actually carried out,” she said.

Park Place South is, in microcosm, the story of a well-intentioned policy gone awry. Advocating homeownership is hardly novel; the Clinton administration did it, too. For Mr. Bush, it was part of his vision of an “ownership society,” in which Americans would rely less on the government for health care, retirement and shelter. It was also good politics, a way to court black and Hispanic voters.

But for much of Mr. Bush’s tenure, government statistics show, incomes for most families remained relatively stagnant while housing prices skyrocketed. That put homeownership increasingly out of reach for first-time buyers like Mr. West.

So Mr. Bush had to, in his words, “use the mighty muscle of the federal government” to meet his goal. He proposed affordable housing tax incentives. He insisted that Fannie Mae and Freddie Mac meet ambitious new goals for low-income lending.

Concerned that down payments were a barrier, Mr. Bush persuaded Congress to spend up to $200 million a year to help first-time buyers with down payments and closing costs.

And he pushed to allow first-time buyers to qualify for federally insured mortgages with no money down. Republican Congressional leaders and some housing advocates balked, arguing that homeowners with no stake in their investments would be more prone to walk away, as Mr. West did. Many economic experts, including some in the White House, now share that view.

The president also leaned on mortgage brokers and lenders to devise their own innovations. “Corporate America,” he said, “has a responsibility to work to make America a compassionate place.”

And corporate America, eyeing a lucrative market, delivered in ways Mr. Bush might not have expected, with a proliferation of too-good-to-be-true teaser rates and interest-only loans that were sold to investors in a loosely regulated environment.

“This administration made decisions that allowed the free market to operate as a barroom brawl instead of a prize fight,” said L. William Seidman, who admired Republican presidents and led the savings and loan bailout in the 1980s.

“When the market work well, you have to have a lot of rules.”

But Mr. Bush populated the financial system’s alphabet soup of oversight agencies with people who, like him, wanted fewer rules, not more.

Kitty Bennett contributed reporting.
Like Minds on Laissez-Faire

The president’s first chairman of the Securities and Exchange Commission promised “a kinder, gentler” agency. The second was pushed out amid industry complaints that he was too aggressive. Under its current leader, the agency failed to police the catastrophic decisions that toppled the investment bank Bear Stearns and contributed to the current crisis, according to a recent inspector general’s report.

As for Mr. Bush’s banking regulators, they once brandished a chain saw over a 9,000-page pile of regulations as they promised to ease burdens on the industry. When states tried to use consumer protection laws to crack down on predatory lending, the comptroller of the currency blocked the effort, asserting that states had no authority over national banks.

The administration won that fight at the Supreme Court. But Roy Cooper, North Carolina’s attorney general, said, “They took 50 sheriffs off the beat at a time when lending was becoming the Wild West.”

The president did push rules aimed at forcing lenders to more clearly explain loan terms. But the White House shelved them in 2004, after industry-friendly members of Congress threatened to block confirmation of his new housing secretary.

In the 2004 election cycle, mortgage bankers and brokers poured nearly $847,000 into Mr. Bush’s re-election campaign, more than triple their contributions in 2000, according to the nonpartisan Center for Responsive Politics. The administration did not finalize the new rules until last month.

Among the Republican Party’s top 10 donors in 2004 was Roland Arnall. He founded Ameriquest, then the nation’s largest lender in the subprime market, which focuses on less creditworthy borrowers. In July 2005, the company agreed to set aside $325 million to settle allegations in 30 states that it had preyed on borrowers with hidden fees and ballooning payments. It was an early signal that deceptive lending practices, which would later set off a wave of foreclosures, were widespread.

Andrew H. Card Jr., Mr. Bush’s former chief of staff, said White House aides discussed Ameriquest’s troubles, though not what they might portend for the economy. Mr. Bush had just nominated Mr. Arnall as his ambassador to the Netherlands, and the White House was primarily concerned with making sure he would be confirmed.

“Maybe I was asleep at the switch,” Mr. Card said in an interview.

Brian Montgomery, the Federal Housing Administration commissioner, understood the significance. His agency insures home loans, traditionally for the same low-income minority borrowers Mr. Bush wanted to help. When he arrived in June 2005, he was shocked to find those customers had been lured away by the “fool’s gold” of subprime loans. The Ameriquest settlement, he said, reinforced his concern that the industry was exploiting borrowers.

In December 2005, Mr. Montgomery drafted a memo and brought it to the White House. “I don’t think this is what the president had in mind here,” he recalled telling Ryan Streeter, then the president’s chief housing policy analyst. It was an opportunity to address the risky subprime lending practices head on. But that was never seriously discussed. More senior aides, like Karl Rove, Mr. Bush’s chief political strategist, were wary of overly regulating an industry that, Mr. Rove said in an interview, provided “a valuable service to people who could not otherwise get credit.” While he had some concerns about the industry’s practices, he said, “it did provide an opportunity for people, a lot of whom are still in their homes today.”

The White House pursued a narrower plan offered by Mr. Montgomery that would have allowed the F.H.A. to loosen standards so it could lure back subprime borrowers by insuring similar, but safer, loans. It passed the House but died in the Senate, where Republican senators feared that the agency would merely be mimicking the private sector’s risky practices — a view Mr. Rove said he shared.

Looking back at the episode, Mr. Montgomery broke down in tears. While he acknowledged that the bill did not get to the root of the problem, he said he would “go to my grave believing” that at least some homeowners might have been spared foreclosure.

Today, administration officials say it is fair to ask whether Mr. Bush’s ownership push backfired. Mr. Paulson said the administration, like others before it, “over-incented housing.” Mr. Hennessey put it this way: “I would not say too much emphasis on expanding homeownership. I would say not enough early focus on easy lending practices.”

‘We Told You So’

Armando Falcon Jr. was preparing to take on a couple of giants.

A soft-spoken Texan, Mr. Falcon ran the Office of Federal Housing Enterprise Oversight, a tiny government agency that oversaw Fannie Mae and Freddie Mac, two pillars of the American housing industry. In February 2003, he was finishing a blockbuster report that warned the pillars could crumble.

Created by Congress, Fannie and Freddie — called G.S.E.’s, for government-sponsored entities — bought trillions of dollars’ worth of mortgages to hold or sell to investors as guaranteed securities. The companies were also Washington powerhouses, stuffing lawmakers’ campaign coffers and hiring bare-knuckled lobbyists.

Mr. Falcon’s report outlined a worst-case situation in which Fannie and Freddie could default on debt, setting off “contagious illiquidity in the market” — in other words, a financial meltdown. He also raised red flags about the companies’ soaring use of derivatives, the complex financial instruments that economic experts now blame for spreading the housing collapse.

Today, the White House cites that report — and its subsequent effort to better regulate Fannie and Freddie — as evidence that it foresaw the crisis and tried to avert it. Bush officials recently wrote up a talking points memo headlined “G.S.E.’s — We Told You So.” But the back story is more complicated. To begin with, on the day Mr. Falcon issued his report, the White House tried to fire him.

At the time, Fannie and Freddie were

VISION GONE AWRY In 2002, Masharn Wilson led Mr. Bush through Park Place South in Atlanta, where 10 percent of homes are now in foreclosure.
The problem with those guys at the White House, they had all the answers and they didn’t think they had to listen to anyone, including the Treasury secretary,” Mr. Oxley said in a recent interview. “They were driving the ideological train. He was in the caboose, and they were in the engine room.”

Mr. Paulson, a former chairman of the Wall Street firm Goldman Sachs, had been given unusual power; he had accepted the job only after the president guaranteed him that Treasury, not the White House, would have the dominant role in shaping economic policy. That shift merely continued an imbalance of power that stifled robust policy debate, several former Bush aides say.

Throughout the spring of 2007, Mr. Paulson declared that “the housing market is at or near the bottom,” with the problem “largely contained.” That position underscored nearly every action the Bush administration took in the ensuing months as it offered one limited response after another.

By that August, the problems had spread beyond New Century. Credit was tightening, amid questions about how heavily banks were invested in securities linked to mortgages. Still, Mr. Bush predicted that the turmoil would resolve itself with a “soft landing.”

The plan Mr. Bush announced on Aug. 31 reflected that belief. Called “F.H.A. Secure,” it aimed to help about 80,000 homeowners refinance their loans. Mr. Montgomery, the housing commissioner, said that he knew the modest program was not enough — the White House later expanded the agency’s rescue role — and that he would be “flying the plane and fixing it at the same time.”

That fall, Representative Rahm Emanuel, a leading Democrat, former investment banker and now the incoming chief of staff to President-elect Barack Obama, warned the White House it was not doing enough. He said he told Joshua B. Bolten, Mr. Bush’s chief of staff, and Mr. Bush in a series of phone calls that the credit crisis would get “deep and serious” and that position underscored nearly every action the Bush administration took in the ensuing months as it offered one limited response after another.

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Instead, the prevailing view at the White House was that the problems in the housing market were limited to subprime borrowers unable to make their payments as their adjustable mortgages reset to higher rates. That belief was shared by Mr. Bush’s new Treasury secretary, Mr. Paulson.

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By that August, the problems had spread beyond New Century. Credit was tightening, amid questions about how heavily banks were invested in securities linked to mortgages. Still, Mr. Bush predicted that the turmoil would resolve itself with a “soft landing.”

The plan Mr. Bush announced on Aug. 31 reflected that belief. Called “F.H.A. Secure,” it aimed to help about 80,000 homeowners refinance their loans. Mr. Montgomery, the housing commissioner, said that he knew the modest program was not enough — the White House later expanded the agency’s rescue role — and that he would be “flying the plane and fixing it at the same time.”
That fall, Representative Rahm Emanuel, a leading Democrat, former investment banker and now the incoming chief of staff to President-elect Barack Obama, warned the White House it was not doing enough. He said he told Joshua B. Bolten, Mr. Bush's chief of staff, and Mr. Paulson in a series of phone calls that the credit crisis would get “deep and serious” and that the only answer was big, internationally coordinated government intervention.

“You got to strangle this thing and suffocate it,” he recalled saying.

Instead, Mr. Bush developed Hope Now, a voluntary public-private partnership to help struggling homeowners refinance loans. And he worked with Congress to pass a stimulus package that sent taxpayers $150 billion in tax rebates.

In a speech to the Economic Club of New York in March 2008, he cautioned against Washington’s temptation “to say that anything short of a massive government intervention in the housing market amounts to inaction,” adding that government action could make it harder for the markets to recover.

**Dominoes Start to Fall**

Within days, Bear Sterns collapsed, prompting the Federal Reserve to engineer a hasty sale. Some economic experts, including Timothy F. Geithner, the president of the New York Federal Reserve Bank (and Mr. Obama’s choice for Treasury secretary) feared that Fannie Mae and Freddie Mac could be the next to fall.

Mr. Bush was still leaning on Congress to rework the tiny agency that oversaw the two companies, and had acceded to Mr. Paulson’s request for the negotiating room that he had denied Mr. Snow. Still, there was no deal.

Over the previous two years, the White House had effectively set the agency adrift. Mr. Falcon left in 2005 and was replaced by a temporary director, who was in turn replaced by James B. Lockhart, a friend of Mr. Bush from their days at Andover, and a former deputy commissioner of the Social Security Administration who had once run a software company.

On Mr. Lockhart’s watch, both Freddie and Fannie had plunged into the riskiest market, gobbling up more than $400 billion in subprime and other alternative mortgages. With the companies on precarious footing, Mr. Geithner had been advocating that the administration seize them or take other steps to reassure the market that the government would back their debt, according to two people with direct knowledge of his views.

In an Oval Office meeting on March 17, however, Mr. Paulson barely mentioned the idea, according to several people present. He wanted to use the troubled companies to unlock the frozen credit market by allowing Fannie and Freddie to buy more mortgage-backed securities from overburdened banks. To that end, Mr. Lockhart’s office planned to lift restraints on the companies’ huge portfolios — a decision derided by former White House and Treasury officials who had worked so hard to limit them.

But Mr. Paulson told Mr. Bush the companies would shore themselves up later by raising more capital.

“Can they?” Mr. Bush asked.

“We’re hoping so,” the Treasury secretary replied.

That turned out to be incorrect, and did not surprise Mr. Thomas, the Bush economic adviser. Throughout that spring and summer, he warned the White House and Treasury that, in the stark words of one e-mail message, “Freddie Mac is in trouble.” And Mr. Lockhart, he charged, was allowing the company to cover up its insolvency with dubious accounting maneuvers.

But Mr. Lockhart continued to offer reassurances. In a July appearance on CNBC, he declared that the companies were well managed and “worsts were not coming to worst.” An infuriated Mr. Thomas sent a fresh round of e-mail messages accusing Mr. Lockhart of “pimping for the stock prices of the undercapitalized firms he regulates.”

Mr. Lockhart defended himself, insisting in an interview that he was aware of the companies’ vulnerabilities, but did not want to rattle markets.

“A regulator,” he said, “does not air dirty laundry in public.”

Soon afterward, the companies’ stocks lost half their value in a single day, prompting Congress to quickly give Mr. Paulson the power to spend $200 billion to prop them up and to finally pass Mr. Bush’s long-sought reform bill, but it was too late. In September, the government seized control of Freddie Mac and Fannie Mae.

In an interview, Mr. Paulson said the administration had no justification to take over the companies any sooner. But Mr. Falcon disagreed: “They absolutely could have if they had thought there was a real danger.”

By Sept. 18, when Mr. Bush and his team had their fateful meeting in the Roosevelt Room after the failure of Lehman Brothers and the emergency rescue of A.I.G., Mr. Paulson was warning of an economic calamity greater than the Great Depression. Suddenly, historic government intervention seemed the only option. When Mr. Paulson spelled out what would become a $700 billion plan to rescue the nation’s banking system, the president did not hesitate.

“Is that enough?” Mr. Bush asked.

“It’s a lot,” the Treasury secretary recalled replying. “It will make a difference.” And in any event, he told Mr. Bush, “I don’t think we can get more.”

As the meeting wrapped up, a handful of aides retreated to the White House Situation Room to call Vice President Dick Cheney in Florida, where he was attending a fund-raiser. Mr. Cheney had long played a leading role in economic policy, though housing was not a primary interest, and like Mr. Bush he had a deep aversion to government intervention in the market. Nonetheless, he backed the bailout, convinced that too many Americans would suffer if Washington did nothing.

Mr. Bush typically darts out of such meetings quickly. But this time, he lingered, patting people on the back and trying to soothe his downcast staff. “During times of adversity, he bucks everybody up,” Mr. Paulson said.

It was not the end of the failures or government interventions; the administration has since stepped in to rescue Citigroup and, just last week, the Detroit automakers. With 31 days left in office, Mr. Bush says he will leave it to historians to analyze “what went right and what went wrong,” as he put it in a speech last week to the American Enterprise Institute.

Mr. Bush said he was too focused on the present to do much looking back.

“It turns out,” he said, “this isn’t one of the presidencies where you ride off into the sunset, you know, kind of waving goodbye.”
As the financial crisis has unfolded, the president's views of the nation's financial health evolved, as did the remedies.

"I don't think we're headed to a disaster," Mr. Bush said in a speech in the Rose Garden last week. "I think we're going to take more time to fully play out. As it does, America's overall foundation, but we can't take economic growth for granted.

The result was a series of piecemeal measures. The president spent years pushing a recalcitrant Congress to toughen regulation of the companies, but was unwilling to compromise when his former chief of staff, Karl Rove, were wary of overly regulating an industry that, Mr. Rove said in an interview, provided "a valuable service to the economy." There were "no economic standards so it could lure back subprime borrowers by insuring similar, but safer, loans. It passed the House but died in the Senate, where Republicans feared that the agency would spread the housing collapse.

Today, administration officials say it was "a mistake for us to have issues." It was "too many people." Mr. Lindsay said. "It would have conformed to the standards that we have in place." But for much of Mr. Bush's tenure, the administration's efforts were met with resistance. The comptroller of the currency blocked the effort, asserting that states had no authority over national banks. "I had to go to the 533,000 last month alone — and his personal problems, left Atlanta. Unable to sell his home for what he owed, he said, he gave it back to the bank last year. Like other communications, Mr. Bush put it this way: "I would not say too much."

"The mighty muscle of the federal government," Mr. Paulson said in a recent interview, has Mr. Bush overruled him. "We've got a boss," he explained, who "understands that when you're dealing with something as unprecedented and fast-moving as this we need to have a different operating style."
The previous year, Mr. Lindsay, the head of a major investment bank, warned of an impending crisis. He had observed a growing trend of low-quality mortgages being securitized and sold to investors. The perception was that these mortgage-backed securities were a safe investment, but Mr. Lindsay knew better. He had worked in the mortgage industry for years and understood the risks associated with such high-risk investments.

In 2005, Mr. Lindsay had voiced his concerns to the Senate, but his warnings were met with skepticism. Many lawmakers dismissed his warnings, stating that the economy was strong and that there was nothing to worry about. Mr. Lindsay was concerned that the lack of oversight and regulations in the mortgage industry was putting the nation at risk.

As the crisis unfolded, Mr. Lindsay’s warnings began to be taken more seriously. In 2007, the government intervened, and the mortgage market began to stabilize. However, the damage had been done. The mortgage crisis had cost the US economy billions of dollars, and many homeowners lost their homes.

The lesson from this crisis is that we cannot afford to ignore the warnings of experts. We must listen to those who have the knowledge and experience to recognize the warning signs and take action to prevent future economic disasters.
**Bush on the Economy**  As the financial crisis has unfolded, the president's views of the nation's financial health evolved, as did the remedies.

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<td><strong>Bush's statements</strong></td>
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<td>July 7 radio address</td>
<td>“Our nation's strong economy is no accident. It is the result of the hard work of the American people and pro-growth policies in Washington.”</td>
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<td>Aug. 31 speech in the Rose Garden</td>
<td>“The markets are in a period of transition, as participants reassess and re-price risk. This process has been unfolding for some time, and it's going to take more time to fully play out. As it does, America's overall economy will remain strong enough to weather any turbulence.”</td>
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<td>Jan. 4 meeting with his Working Group on Financial Markets</td>
<td>“This economy of ours is on a solid foundation, but we can't take economic growth for granted.”</td>
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<td>Feb. 28 news conference</td>
<td>“I don't think we're headed to a recession, but no question we're in a slowdown.”</td>
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<td>March 16</td>
<td>The government rescues Bear Stearns from collapse by arranging to finance its acquisition by JPMorgan Chase.</td>
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<td>Sept. 15 Lehman Brothers declares bankruptcy. Merrill Lynch agrees to be acquired by Bank of America.</td>
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<td>Sept. 16 The government announces an $85 billion emergency loan to rescue American International Group.</td>
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<td>Sept. 20 President Bush requests authority for the Treasury Department to buy as much as $700 billion in distressed mortgage-related assets.</td>
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<td>Sept. 25 Washington Mutual is seized.</td>
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<td>Dec. 19 Bush administration announces bailout of General Motors and Chrysler.</td>
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<td>March 17</td>
<td>meeting with Treasury Secretary Paulson</td>
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<td>April 25 statement on tax rebates</td>
<td>&quot;It's obvious our economy is in a slowdown. Fortunately, we recognized the signs early and took action.&quot;</td>
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<td>Sept. 20 news conference</td>
<td>&quot;This is a big package, because it was a big problem.&quot;</td>
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<td>Oct. 20 roundtable in Alexandria, La.</td>
<td>&quot;If I felt that the crisis could be contained in Wall Street, then I'd have taken a different course of action.&quot;</td>
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<td>Dec. 17 interview with Fox News</td>
<td>&quot;I am a free-market guy, but I'm not going to let this economy crater in order to preserve the free-market system.&quot;</td>
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