1

Financial Crisis Origin

A variety of factors contributed to the U.S. economy's recession, which exhibited catastrophic symptoms of a housing bubble toward the end of 2007. Prompted by low interest rates beginning on January 3, 2001, and overlooked by the regulatory agencies, Americans borrowed excessively for home mortgages. This first phase of extensive mortgage financing for eventual home ownership extended from 2001 to 2004. Then from June 30, 2004, interest rates began moving up and these mortgages became unmanageable and ultimately subprime. Marked by escalating foreclosures, this second phase of their conversion into the subprime category intensified from 2005 to 2007. The crashing valuations of mortgage-based assets held by U.S. financial institutions, among them government-supported Fannie Mae and Freddie Mac, and by the American Insurance Group (AIG), required their bailout by the Treasury and the Federal Reserve in late September 2008.

These subprime mortgages were also repackaged into salable assets by savvy operators who sold them to investors, which included large Wall Street banks. This securitization activity via slicing and dicing of the troubled mortgages intensified in 2007. When brought into the act, Congress passed a $700 billon Troubled Asset Relief Program (TARP) for rescuing the banking system.

A major financial breakdown was avoided.

The housing bubble, financed by excessive mortgage lending that plunged the U.S. financial sector into a severe crisis, required its bailout in late 2008 and early 2009. To understand this unprecedented rescue operation, it is necessary to examine the U.S. economy's recovery from the March 2000 collapse of the dotcom bubble.

I. Easy Monetary Policy and Tax Cuts

Beginning in January 2001, the Federal Reserve followed an easy monetary policy for pulling the economy out of the recession that was induced by the collapse of the dotcom bubble in March 2000. It lowered the federal funds rate—which sets the overnight interbank borrowing cost—from 6 to 1 percent on January 3, 2001, and kept it there until June 30, 2004. At the same time, tax cuts, proposed by President George W. Bush and approved by Congress in 2001 and 2003, provided the fiscal stimulus.

Americans began acquiring low-interest-rate mortgages to buy homes. The housing boom, feeding into vigorous construction activity from 2001, provided the impetus to economic recovery, which gathered momentum in 2003 and 2004. The economy recorded a 2003 third quarter GDP growth of 7.5 percent over the preceding quarter. GDP growth rate in 2004 was an exceptional 3.6 percent.

An external factor, combined with the easy monetary policy from 2001 through June 2004, added to the continuing economic resurgence marked by the housing bubble.

Saving Flow from Outside

The emergence of China as a fast-growing economy, with a real annual GDP growth of 8 to 10 percent starting in 1980, represented a new phenomenon in the history of the modern world. By 2005, China's gross domestic investment at 41.2 percent of its GDP was exceeded by its gross saving rate at 49.5 percent, with the rising profitability of the Chinese corporate sector accounting for 70 percent of these savings.[1] At the same time, a booming export sector contributed to the double-digit annual GDP growth of 10 to 11 percent from 2003 to 2006. The People's Bank of China aggressively pumped Chinese currency into the foreign exchange market in exchange for dollars from exporters, which it invested in U.S. Treasury bonds and other foreign currency holdings.[2]

This generous bounty implied that the U.S. Treasury had to borrow less internally. U.S. mortgage rates, steered by the federal funds rate of 1 percent, remained low, which encouraged Americans to take on massive mortgages for home ownership. These mortgages turned into unsustainable burdens as the Federal Reserve began raising the federal funds rate after June 30, 2004. The rate rose to 5.25 percent by June 29, 2006, where it remained until August 17, 2007.

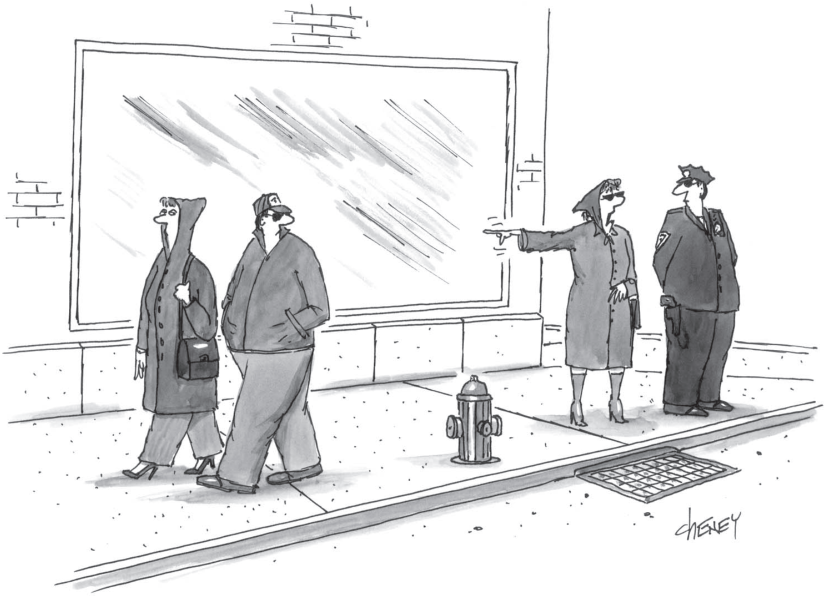
The process of unconstrained home ownership was aided by the failure of consumer protection arrangements that were encumbered by the presence of several agencies responsible for protecting household interests by ensuring regulatory compliance on the part of brokers, mortgage companies, and banks. This is examined in the next section.

II. Failure of Regulatory Arrangements

In the years leading to the crisis, Wall Street banks, flush with cash, were eager to acquire mortgage-backed securities. They encouraged mortgage companies and brokers by steering potential borrowers into high-risk loans. People borrowed beyond their means because appraisers inflated the values of properties that prospective buyers were interested in. Borrowers were led to believe that they had undertaken a standard fixed-rate mortgage only to learn later that their mortgage was a complicated variable-rate contract. Banks could choose their own regulators and switch to a less scrupulous regulator. Federal regulators occasionally sidestepped tougher state requirements that could have prevented such predatory lending activities. Hardly anyone debated the “regulatory capture” by the federal agencies while risky lending practices proliferated.

Mortgage-securitizing banks were not responsible for abuses in the original mortgages. Large American and European banks securitized these subprime mortgages and sold them to global investors with a view to making a profit.

According to the Center for Public Integrity, the top 25 subprime originators had advanced almost $1 trillion in loans to more than 5 million borrowers between 2005 and 2007, the peak of subprime lending. Many of these borrowers’ homes were eventually repossessed.[3]



"Officer, that couple is just walking away from their mortgage!"

Would you pay $103,000 for this Arizona fixer-upper? (Reprinted by permission of *The Wall Street Journal*, copyright © 2009 Dow Jones & Company, Inc. All Rights Reserved Worldwide.)

Among mortgage firms that had recklessly extended loans to home owners was Integrity Funding LLC, which had given a $103,000 home equity loan in early 2007 to Marvene Halterman for a little blue house on West Hopi Street in Avondale, Arizona. It was a 30-year mortgage with an adjustable rate that started at 9.25 percent and was capped at 15.25 percent.[4] Halterman, who had bought the house four decades earlier for $3,500, had a long history of unemployment and other problems. She collected junk, and the yard at the house "was waist high in clothes, tires, laundry baskets and broken furniture. . . . By the time the house went into foreclosure in August [2009], Integrity had sold that loan to Wells Fargo & Co., which had sold it to a U.S. unit of HSBC Holdings PLC, which had packaged it with thousands of other risky mortgages and sold it in pieces to scores of investors."[5] A series of similar out-of-bounds decisions had set the stage for the unfolding of the worst financial crisis to hit the United States since the Great Depression.

Why was mortgage lending not regulated? According to the Center for Public Integrity, the big financial players spent $3.5 billion lobbying Washington from 2000 to 2009 and donated $2.2 billion to political campaigns. Wells Fargo Financial, owned by the bank, contributed almost $18 million to election campaigns and lobbying, equally divided between Republicans and Democrats.[6]

(City of Avondale, AZ; Code Enforcement Division.)

Would the crisis have been averted if mortgage lenders' risk management and underwriting practices were more effectively regulated despite the Fed's low interest rate policy from 2001 to 2006? The next section explores this question.

III. What Caused the Crisis: Lax Regulations or Easy Monetary Policy?

Alan Greenspan, who was chairman of the Federal Reserve from 1987 to 2006, was grilled by the Financial Crisis Inquiry Commission on April 7, 2010, about the Fed's role in the onset of the crisis. Didn't the Fed's failure to curb subprime lending amid the unfolding of the housing bubble fall into the category of "oops"? Phil Angelides, commission chairman, reiterated: "My view is you could have, you should have, and you didn't."[7] Defending his record, the former chairman said: "I was right 70 percent of the time, but I was wrong 30 percent of the time. What we tried to do was

(© 2010, Barry Blitt. Reprinted by permission.)

the best we could with the data that we had."[8] Referring to the ballooning subprime mortgages, he said: "If the Fed . . . had tried to thwart what everyone perceived as . . . an unmitigated good, then Congress would have clamped down on us." Then again: "If we had said we're running into a bubble [of house prices] and we need to retrench, the Congress would say, 'We haven't a clue what you're talking about.' "[9]

The Fed chairman's policy handling prompted this response from a *New York Times* columnist: "If the captain of the *Titanic* followed the Greenspan model, he could claim he was on course at least 70 percent of the time too."[10]

Current Federal Reserve Chairman Ben Bernanke also defended the Fed's record by distinguishing between regulatory failure and low interest rates as factors contributing to the housing bubble. The easy interest rate regime prevailed from 2001 to 2006—he was a member of the Board of Governors of the Federal Reserve for most of that period. In his remarks at the annual meeting of the American Economic Association in early January 2010, he said: "When historical relationships are taken into account, it is difficult to ascribe the house price bubble either to monetary policy or to the broader macroeconomic environment."[11] Earlier Bernanke had referred to the flow of saving from China that had kept U.S. interest rates low. Wasn't it necessary therefore to moderate the Fed's easy monetary policy?

Alicia H. Munnell, a former research director at the Federal Reserve Bank of Boston, provided an insightful assessment: "The Fed is this powerful and privileged institution, and it has a bully pulpit that it can use even when it doesn't have the direct authority to regulate . . . it's never appropriate for a Federal Reserve official to say, 'It's not our job.' In some ways, Alan Greenspan is saying that."[12] Clearly the Federal Reserve, in charge of the financial regulatory setup, should have been aware of its massive policy shortcomings. Wouldn't the borrowing binge have been moderated or even cut short if it had raised the federal funds rate earlier and adequately? Weren't community banks around the country, which issued mortgages and chose their own regulators for the purpose, under the supervisory umbrella of the Federal Reserve? At the same time, shouldn't the Securities and Exchange Commission have extended its regulatory oversight to the activities of financial institutions that were recklessly packaging these subprime mortgages and selling them to investors, which included large Wall Street banks?

In any case, while the Fed defaulted in its policy-making and regulatory roles, were banks poised to manage the hit from the subprime mortgage holdings in their portfolios? Let's examine that question.

IV. Consequences of Excessive Securitization of Subprime Mortgages by Banks

Bank holdings of securitized mortgages were diversified across regions of the United States. One region may suffer a crash, but the property market would not collapse across the country as a whole. Besides, in the first half of 2007, large western banks had posted a record $425 billion in aggregate profits and had capital reserves that vastly exceeded the minimum required by international banking rules. Global banks alone were estimated to hold core capital (known as tier 1) of $3.4 trillion against their assets.

However, losses on the securitized mortgage assets turned out to be so large in the second half of 2007 that they started eating up bank capital. Between June and late November of 2007, more than $240 billion had been wiped off the market capitalization of the 12 largest Wall Street banks. Banks stopped trusting one another. They refused to lend to one another and hoarded their cash.

As the cash shortage intensified, New York, London, and Zurich bankers sought capital infusions from Asian and Middle Eastern sovereign funds estimated at about $3 trillion. Citigroup Inc. was the first to get an infusion, in late November 2008, of $7.5 billion from the Abu Dhabi Investment Fund, the world's biggest sovereign fund. UBS and Merrill Lynch followed.

The crisis of confidence—the loss of "animal spirits"—affected not only the banking sector, but also the stock market, the Treasury bond market, and, most of all, American households struggling with the burden of mortgage payments and home foreclosures as 2007 wound down. In a parallel to the stock market crash of 1929, the market experienced its worst week in October 3. The interest rates on three-month U.S. Treasury bills veered into the negative range in September 2008, for the first time since 1941. Caught in this erosion of animal spirits, American consumers cut back their spending. Business and consumer confidence needed to be revived.

It was time for the Federal Reserve to act. On January 21, 2008, Martin Luther King Day, Chairman Bernanke convened a videoconference of the Federal Open Market Committee and convinced the committee to opt for a king-sized rate cut of three-quarters of a percentage point to 3.50 percent, with a decisive hint of more to come. "It was the first time the Fed had cut rates in between regularly scheduled meetings since the aftermath of September 11, 2001. Although no one realized it at that time, Mr. Bernanke's new strategy was born that day. Whatever it takes."[13]

As 2008 advanced, the stock market began its volatile and sharp descent from a height of 13,000 (registered by the Dow Jones Industrial Average) in April 2008 to 6,500 in February 2009. At the same time, accelerating home foreclosures and subprime mortgages took a toll on mortgage-based assets of banks, mortgage-lending giants Fannie Mae and Freddie Mac, and AIG, the largest American insurer. The rescue called for a joint effort on the part of the Treasury and the Fed, as we see in the next section.

V. The Joint Treasury–Fed Rescue Deals in 2008

The earliest bailout, jointly brokered by the Treasury and the Fed, related to Bear Stearns.

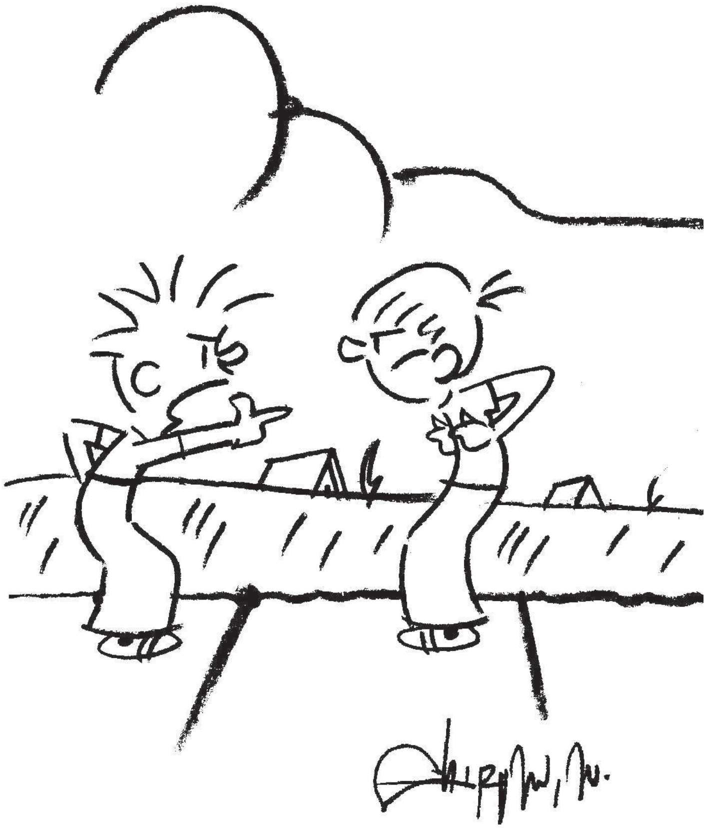
JPMorgan Chase Takeover of Bear Stearns

In March 2008, JPMorgan Chase & Co. bought the collapsing Bear Stearns in a deal that was brokered jointly by former Treasury Secretary Hank Paulson and Bernanke with a transfer of Bear Stearns's troubled assets of $29 billion to the Treasury. In the aftermath of the staggering bailouts that were to follow toward the end of the year, the Bear Stearns takeover by the Treasury was a minor exercise of ownership transfer.

On September 6, the government took over mortgage-lending giants Fannie Mae and Freddie Mac as they teetered near collapse with a portfolio of home loans worth $5.5 trillion out of a total estimated at $10 trillion.

Fannie Mae and Freddie Mac Takeover by the Treasury

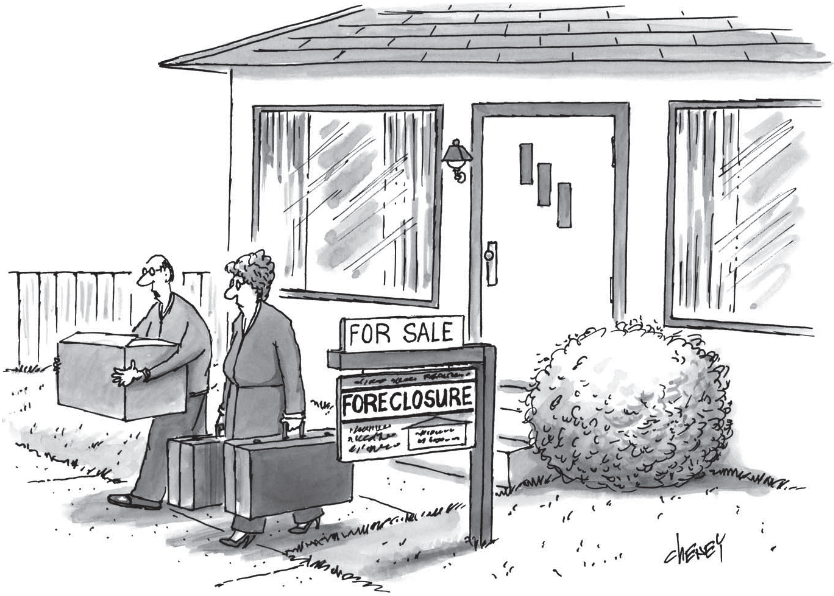
For over half a century, Fannie and Freddie enabled Americans to buy homes as the two agencies purchased loans from mortgage banks and provided them with cash for making more loans. It was not the purpose of Fannie and Freddie to directly extend loans to people. The two agencies had a political and legal mandate, prescribed by the U.S. Department of Housing and Urban Development, to support low-income housing by acquiring loans "with lower credit standards." From 2005, the two agencies increased their share of mortgages for affordable housing for moderate-income borrowers living in "underserved areas." The lower credit standards,



"Oh, yeah? Well, my dad bailed out your dad!" (From *The Wall Street Journal,* permission Cartoon Features Syndicate.)

however, meant that, over time, they acquired loans that borrowers could not afford.

As defaults and foreclosures mounted, the two agencies increasingly held worthless assets on their balance sheets, and they needed cash inflow in order to avoid bankruptcy. In September 2008, the Treasury extended a loan of $200 billion each to the two companies and took charge of running them under a conservatorship until they revived. "A failure [of Fannie and Freddie] would affect the ability of Americans to get home loans, auto loans, and other consumer credit and business finance. [Their] failure



"Well, this is one way to keep the kids from moving back home."

(© Tom Cheney / The New Yorker Collection / www.cartoonbank.com.)

would be harmful to economic growth and job creation," Treasury Secretary Paulson announced in a Washington press conference.

Having received the funding, Fannie and Freddie continued to modify the loans on their balance sheets in order to keep people in their homes.

LOAN MODIFICATION PROGRAMS OF FANNIE AND FREDDIE

One of the loan modification programs involved the agencies buying defaulted loans directly from home owners. They also acquired delinquent loans from pools of mortgage-backed securities (that they had guaranteed) and kept them in their investment portfolios.

In an innovative wrinkle, instead of modifying the loans of home owners facing foreclosure, the agencies agreed to allow the home owners to stay in their homes and rent them at a cost lower than their mortgage payments. Fewer foreclosures would stabilize communities and the housing market as well. But there was a catch. If the agencies continued these programs until home prices stabilized, it was entirely possible that they would use up the funding assigned to them by the Treasury—$200 billion each, all of which was free from congressional oversight.

According to the Treasury, Fannie and Freddie needed a longer financial leash. They could not be burdened with the requirement that they reduce their portfolios of mortgages and mortgage-backed securities, which had reached a total of $1.5 trillion. On December 24, 2009, the Treasury, which owned 79.9 percent of the mortgage giants, favored them with a Christmas Eve offering. It suspended for three years the combined $400 billion *limit* on the bailout allowances with which they operated their programs. In another retreat, the Treasury and the Federal Housing Finance Agency also approved significant cash bonuses for top Fannie and Freddie executives. In addition, the agencies would not be required to sell mortgage-backed securities from their portfolios in order to trim their balance sheets. In any case, the market for these tainted assets was weak. Besides, the Federal Reserve was planning to wind down its program of buying mortgage-backed securities by March 31, 2010. Instead, Freddie and Fannie could buy them from the market and keep mortgage interest rates low.

Was the Treasury too lenient with Fannie and Freddie and, in effect, with delinquent home owners who lacked the cash to afford their homes and needed to be rescued? Nearly 15 million American home owners owed their creditor banks more than their homes—in which they owned no equity—were worth. They would be ready to accept foreclosures rather than continue making payments on their outstanding balances. The loan modification program deliberately did not compel banks to write down these balances, which meant that more banks would need to be rescued via taxpayer bounty. The loan modification arrangement only required delinquent home owners to pay lower interest on their mortgages. A faster rate of foreclosures would have thrown millions out of their homes and destabilized entire communities. Fannie and Freddie, endowed with substantial financial resources, would implement the loan modification agenda cautiously.

Caution notwithstanding, the two siblings had run up losses of $126.9 billion in 2009. Both are outside congressional oversight, but shouldn't the taxpayers who will ultimately bear the costs of bailing them out of the mortgage mess they created receive an honest accounting of their exposure? Shouldn't the toxic twins, both government-sponsored entities, be brought openly onto the federal budget with respect to the subsidies they poured into the housing market?

REFORMING FANNIE AND FREDDIE

Opinions differed. Treasury Secretary Tim Geithner informed Congress in late February 2010 that Fannie and Freddie would be reformed in 2011 so that the mortgage catastrophe did not happen again. Representative Barney Frank (D-MA) declared that he would have them abolished in their current avatar, but he fell short of presenting a plan outline. In early March, Representative Scott Garrett (R-NJ) introduced the Accurate Accounting of Fannie Mae and Freddie Mac Act, which would require that taxpayers receive an accurate accounting of the activities of the two behemoths. As 2010 was an election year, Republicans sought opportunities to take a stab at the government's financing accountability.

Continuing the debate, Spencer Bachus, ranking Republican member of the House Financial Services Committee, went further, asking whether Fannie and Freddie should be phased out within four years, whether private mortgage financing be reinvigorated, and whether the original hybrid model of Fannie and Freddie operating as private companies with government financial backing should be gotten rid off once and for all. In response, Treasury Secretary Geithner acknowledged the limitations of the hybrid arrangement: "We should not re-create that fatal mix of public and private shareholders in the same institution." But a government guarantee to facilitate a stable housing market would, in his view, continue, although that support needed to be priced appropriately so as not to burden the taxpayers excessively. Nevertheless, according to Geithner, an outright privatization of Fannie and Freddie was out of the question.[14]

By mid-June 2010, Fannie and Freddie, which held 95 percent of U.S. housing mortgages in their portfolios, reported a massive slump in their share values. Fannie's shares, which traded at $60 per share in September 2007, had collapsed by 99 percent, to about 55 cents. Freddie's exchanged for 74 cents per share, down 98 percent from $60 in September 2007. The New York Stock Exchange, which requires minimum trading guidelines for shares to trade above $1 a share, delisted both from its trading platform on June 16.

Their banishment from the New York Stock Exchange notwithstanding, Fannie and Freddie continued acquiring foreclosed homes, removing owners who could not afford them, selling these units, and extending

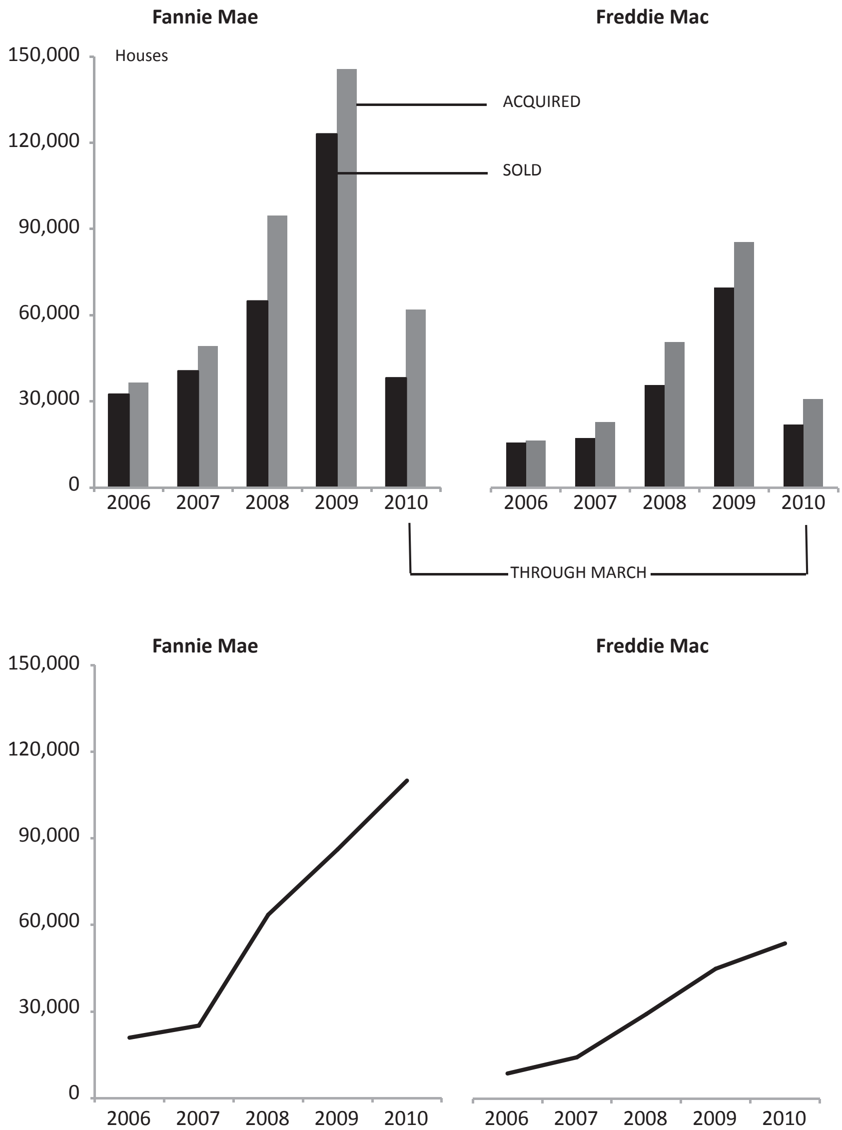


Figure 1.1.
Total Mortgage Holdings of Fannie Mae and Freddie Mac. (Fannie Mae, Freddie Mac.)

mortgage loans to new owners. From 2006 to March 2010, they had acquired foreclosures faster than they could sell them (figure 1.1). During the same period, their ballooning housing inventories had converted them into the country's largest landlords supported by taxpayer bounty. In view of the massive holdings in subprime mortgages on the agencies' balance sheets, their outright privatization would be an unwise public policy choice in the Treasury's judgment. In the meantime, Fannie and Freddie must keep the homes, cover their utility bills and pay their taxes, and hire thousands of contractors to maintain the homes, mow the lawns, and clean the pools. The maintenance cost of these properties was $13 billion in the second quarter of 2010.[15] But the homes could not be disposed of because the housing market was unstable. A private owner would acquire money-losing mortgages at throwaway prices, dispossess the mortgage holders, and resell the properties when the housing market revived. By contrast, Fannie and Freddie had allowed such mortgage holders to continue occupying their homes under modified arrangements. The financial reform legislation that President Barack Obama signed on July 21, 2010, required the Treasury to submit proposals to overhaul Fannie and Freddie no later than January 1, 2011. The public was invited to make suggestions.

Not every troubled company was as lucky as Fannie and Freddie in continuing to get life support from the American taxpayer. On September 15, 2008, Lehman Brothers Holdings Inc., a 150-year-old firm employing 25,000 workers, was forced to initiate the largest bankruptcy proceedings in U.S. history.

Lehman Brothers

Why wasn't Lehman saved? After all, the government had allowed JPMorgan Chase to buy and rescue Bear Stearns. Perhaps Congress did not want to undertake another bailout on the heels of Fannie and Freddie just a week before. Lehman's balance sheet was excessively leveraged without adequate collateral. Lehman's global derivatives with a notional face value of $39 trillion included deals with 8,000 counterparties. The derivatives, split into numerous strands, presented a daunting challenge to its computer platforms and technology staff. Despite Lehman's being smaller than Merrill Lynch and, unlike Merrill Lynch, having no ties with either Main Street or Wall Street and despite prodding by the Treasury, Lehman could not find a partner with deep pockets to team up with. "In retrospect, if you had to choose one firm to throw under the bus to save everyone else, you would choose Lehman."[16]

A year later, former Treasury Secretary Paulson reminisced in his memoir about his decision to let Lehman go under: "Only after Lehman Brothers failed did we get the authorities from Congress to inject capital into financial institutions. . . . Amazingly, U.S. government regulators still lack the power to wind down a nonbank financial institution outside bankruptcy."[17] Without Lehman's collapse, Congress would not have been activated to pass the $700 billion TARP on October 3, 2008, aimed at saving the financial system.

AIG was the final item on the Treasury–Federal Reserve's bailout list.

AIG Rescue

On September 16, 2008, the Federal Reserve rescued AIG with an $85 billion loan, and the U.S. government got a 79.9 percent equity stake in the company in the form of warrants, called equity participation notes. The Fed loan was secured with AIG's insurance business assets, and the government's equity stake could turn out to be profitable with the rebound of the market. "A disorderly failure of AIG could add to already significant levels of financial market fragility," the Fed said in a prepared statement. Indeed, after Congress passed TARP to bolster the financial health of U.S. banks, AIG received $49 billion from the program.

The AIG rescue saved the company—but was it proper? Not according to an audit conducted more than a year later by the special inspector general for TARP, Neil Barofsky. According to his severe admonition, the New York Federal Reserve under the presidency of Geithner had paid 100 cents to the dollar for the complex securities that AIG trading partners (among them, Goldman Sachs Group Inc., Merrill Lynch, and Société Générale) had insured with AIG. These credit market bets in the bank portfolios, amounting to $60 billion, were tied to the collapsing mortgage-linked securities and were worth much less. Of course, the banks desperately tried to get AIG to post adequate collateral to cover the securities, which it could not do. Instead, the government bought these securities from the banks, which then cancelled their insurance contracts with AIG and freed it from the pressure to post matching collateral. AIG was rescued. So were the banks, its partners—with full coverage from U.S. taxpayers.

"We've decided that it would be wise to dissolve the corporation and form a cult." (From *The Wall Street Journal,* permission Cartoon Features Syndicate.)

On November 19, 2009, Treasury Secretary Geithner defended his decision to rescue AIG when he was New York Fed president. In his view, the government lacked the power to rescue a company such as AIG, which was not legally set up as a bank. "Coming into AIG, we had, basically, duct tape and string." It was, however, critical to keep AIG liquid, whereas Lehman, a nonbank company, could be allowed to disappear. Did this imply double standards?

In the autumn of 2008, the policy-making team was driven more by trial-and-error problem solving than by personal preferences. The escalating turmoil demanded seat-of-the-pants action, often with limited information and little time to think. Of course, hindsight is 20-20—and every decision at each stage of the crisis would end up being evaluated in the great American tradition of Monday-morning quarterbacking. In late May 2010, the Congressional Oversight Panel for TARP held a hearing about the government bailout of AIG. Several questions were raised, but the most crucial was: When will AIG repay the $83.2 billion it owed to the Federal Reserve? The company had sold off some assets, paid down its debts, and had become a smaller entity. Ultimately, AIG would shrink to international general insurance (including property and casualty) and domestic life insurance. It might continue insuring mortgages. Everything else had been closed or sold or put up for sale. Perhaps AIG will repay the Fed's loan in 2011. But would it ever become profitable enough for the Treasury to recover its $49 billion TARP bailout funding?

In late September 2010, AIG's board of directors floated a scheme for consideration by government overseers that would provide an affirmative nod to the question. Under the plan, the Treasury could convert the $49 billion of preferred shares in its possession into common shares. That would initially raise the Treasury's stake in AIG from the current 79.9 percent to greater than 90 percent. The Treasury would then gradually sell off the shares to private investors. That would reduce its ownership stake in the company and perhaps earn it a profit if the shares rose in value. The Treasury exit plan could begin as early as the first half of 2011. If the plan succeeded, the Treasury could argue that the initial investigation undertaken by lawmakers with regard to the government bailout of AIG was off the mark.

An even more damaging after-the-event scrutiny was mounted by congressional watchdogs with regard to Bank of America's purchase of Merrill Lynch.

Bank of America Takes Over Merrill Lynch

In December 2008, Bank of America bought Merrill Lynch for $50 billion. But before the deal could be consummated, Bank of America CEO Kenneth Lewis, worried about the deteriorating toxic assets of Merrill Lynch, called Bernanke and Paulson and told them that he was thinking of pulling out of the deal. Terrified by the prospect of panic in the financial market that this might set off, they loaned Bank of America an additional

$20 billion from TARP funding. Almost 10 months later, Lewis, Bernanke, and Paulson appeared before the House Committee on Oversight and Government Reform on plausible charges of having worked up a secret deal without the knowledge of Merrill Lynch shareholders and then arranging a cover-up. At the end of the day, Merrill had to be saved from a collapse, and Lewis took the heat and defended the deal. "I would say [Bernanke and Paulson] strongly advised and they spoke in strong terms, but I think it was with the best intentions," he said in his testimony on June 11, 2009. Months later at a conference of Japanese investors in Tokyo, he waxed eloquent about his mission: "I began my tenure as CEO of this company with a vision for a global, integrated, multiproduct financial services company. . . . Merrill Lynch will help bring this vision to life." He also invoked a Japanese proverb in support of his mission, saying, "Vision without action is a daydream. . . . Action without vision is a nightmare."

More than a year later, Kenneth Lewis's nightmare was not over. In early February 2010, Andrew Cuomo, New York State Attorney General, filed a civil fraud lawsuit against Bank of America, Ken Lewis, and the bank's Chief Financial Officer Joseph Price, accusing them of "duping shareholders and the federal government in order to complete a merger deal with Merrill Lynch."[18] In other words, the management of Bank of America intentionally concealed massive losses at Merrill in order for the shareholders to approve the deal. In hindsight, Bank of America's takeover of Merrill Lynch did not seem to have hurt U.S. taxpayers. Bank of America has since repaid the TARP bailout fund, and Merrill's investment bank has turned the corner into reporting profit. Andrew Cuomo, who was planning to run for governor of New York State, was evidently catching a moment under the sun to play politics.

In September 2008, the Bank of America takeover of Merrill Lynch was the least costly and controversial item on the firefighting agenda of the Treasury and the Federal Reserve for rescuing the financial system as a whole, which was heading toward a collapse. It was urgent to get Congress into the act. The next section describes what Congress did.

VI. Congress to the Rescue

In the midst of this frenzy of rescues, the stock market had continued to fall sharply, and the yield on U.S. short-term Treasury bonds had sunk to zero as risk-averse investors flooded to these safest of assets. It was time to bring Congress into a big-time rescue plan. On September 18, 2008, Paulson and Bernanke (accompanied by Chris Cox, chairman of the Securities and Exchange Commission) went to Capitol Hill to alert the congressional leadership. "'No economy has ever faced the financial meltdown we're facing without undergoing a major recession,' [Bernanke] told the stunned leadership behind closed doors. Without congressional action, it would be deep and prolonged."[19]

In the original version of the rescue legislation, the $700 billion in funding was intended to be for the Treasury to buy the toxic assets of the banks rather than provide them with cash infusions. But the House voted down the proposed bill. In the view of the legislators, voters were angry and in no mood to bail out a bunch of profligate bankers who sought to be saved via taxpayers' cash. Representative Frank consoled Secretary Paulson: "Sometimes you have to let the kid run away from home. He gets hungry, he comes back."[20] In its revised and final version, TARP, with its $700 billion in funding, included not only subprime mortgage assets but also other financial instruments in the rescue operation.

Frank provided the final word on the rescue package: "You can't go out and shoot the bankers. You can't have an economy without a functioning credit system. People are angry. They're furious. But you have no option but to live with these people."[21]

Great Depression No. 2 was avoided by the lawmakers with a timely but ironic show of generosity in favor of the bankers.