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Deputy Chief of Staff, White House Office of
Kaplan, Joel

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Folder Title:

Financial Crisis - 2008

Withdrawn/Redacted Material

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DOCUMENT NO.	FORM	SUBJECT/TITLE	PAGES	DATE	RESTRICTION(S)
001	Email	URGENT: Meeting at 11:30AM SATURDAY.. - To: Joel Kaplan, et al. - From: Paul Brown	1	10/11/2008	P6/b6;
002	Report	Taking a Hard New Look at a Greenspan Legacy	6	10/13/2008	P5;
003	Letter	[Cover Letter] - To: POTUS - From: Raul Yanes	1	10/17/2008	P1/b1; P5;
004	Report	[Report]	7	N.D.	P1/b1;

COLLECTION TITLE:

Deputy Chief of Staff, White House Office of

SERIES:

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RESTRICTION CODES

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F: Kaplan
10/15/08



BUCK SLIP

Comptroller of the Currency
Administrator of National Banks

To: Comptroller Dugan

Date: October 15, 2008

SUBJECT: Impact of Treasury Senior Preferred Stock Program

In response to some of the press today regarding Treasury's Senior Preferred Stock Program and reports that few community banks plan to participate, the attached graph and chart illustrate some key points that should be made:

- The 9 largest banks that will participate in the program represent 54% of total commercial bank assets and 50% of total deposits in the banking system. As the graph indicates, these banks, collectively, have local community presence, through their branch networks, for much of the country – including those areas that have been hardest hit by the real estate crisis.
- The top 50 commercial bank holding companies, collectively, account for 77% of total commercial bank assets and 74% of total deposits and account for the vast number of assets and deposits in the banking system and thus are the key players in terms of restoring the banking system.
- Conversely, while banks under \$250 million represent 70% of the total number of commercial banks, they account for less than 5% of total banking assets and slightly more than 5% of total deposits. While some of these institutions may be vocal about whether they need this program, the simple fact is that they account for a very small fraction of the system's assets and deposits.

Tim Long
Senior Deputy Comptroller
Bank Supervision Policy

From: Brown, Paul A.

Sent: Saturday, October 11, 2008 10:36 AM

To: Kaplan, Joel; Hennessey, Keith; Price, Daniel M.; David.McCormick@do.treas.gov; jefferyR@state.gov; 'Clay.Lowery@do.treas.gov'; 'Sullivan, Daniel S';

Mark.Sobel@do.treas.gov; 'Jim.Wilkinson@do.treas.gov'; 'Jim.Wilkinson@do.treas.gov';

Herrmann, John M.; Simonetti, John M.; Price, Daniel M.; Brown, Paul A.

Cc: 'Jamie.Franco@do.treas.gov'; 'Guest, C Colin'; EEB-A-STAFF-ASSISTANTS-DL;

'Dingman, Lacey M'; 'Joann.Tissue@do.treas.gov'

Subject: URGENT: Meeting 11:30AM SATURDAY at the EEOB on a Mtg on the Financial Crisis

At the request of Steve Hadley and Secretary Rice, Dan Price would like to meet to discuss possible structure and outcomes from a meeting on the financial crisis. This meeting will take place today at 11:30am-12:30pm in the EEOB, Room 180. The following are invited to attend, please confirm participation by responding, with clearance data ASAP for those without EOP passes, to John Simonetti and myself.

thank you and apologies for the extremely short notice.

Invitees

Joel Kaplan

Keith Hennessey

Dan Price

Dave McCormick

Reuben Jeffery

Clay Lowery

Dan Sullivan

Jim Wilkinson

John Herrmann

Mark Sobel

Paul Brown

thanks,

Paul

Paul A. Brown

Director for G-8

National Security Council staff

tel: 202.456.9293

fax: 202.456.9280

mobile: (b)(6)

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FORM	SUBJECT/TITLE	PAGES	DATE	RESTRICTION(S)
Report	Taking a Hard New Look at a Greenspan Legacy	6	10/13/2008	P5;

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F: Kaplan

October 20, 2008

Josh / Joel.

The attached piece from *Portfolio* magazine chronicles the birth of the derivatives market, specifically the combination of securitization and credit derivatives.

It's a fascinating story about what has become a critical part of today's crisis. In telling it, the author also gives a mini-primer on some of the more complex concepts.

Well worth the read in my judgment.

Blake

Wall Street

The \$58 Trillion in the Room

by Jesse Eisinger | [See Archive](#)

The roots of this year's financial crisis go back to a small team of bankers at J.P. Morgan in New York. Now, their invention—credit derivatives—has helped bring down Wall Street and has left Morgan with its biggest exposure of all.

At a time when the reputation of bankers has been shredded, Bill Demchak is a throwback. The day I meet him, the financial world is once again poised on the brink of destruction. The Dow Jones Industrial Average lost 358 points the day before and is already down another 150 this morning. Yet the green-eyed Demchak, in pleated khakis hiked up unfashionably high on his waist, seems preternaturally calm—especially for a man who, unwittingly, has had a hand in bringing Wall Street to its knees.

Demchak, now the vice chairman of PNC Financial in Pittsburgh, returned to his hometown in 2002 to help rescue the bank after it became mired in an accounting scandal. Under Demchak and the rest of its new management team, PNC has avoided most of the terrible mistakes of its Wall Street peers by spurning bad mortgages, dubious off-balance-sheet deals, and questionable corporate loans. It's now one of the best-performing banks in the country.

But before he had this life, Demchak had another, as the leader of a small group at J.P. Morgan in New York that pioneered the kind of financial instruments that eventually led to this autumn's wreckage on Wall Street. The J.P. Morgan team created and then industrialized credit derivatives, which have enveloped the global markets, growing to a mind-numbing \$58 trillion worth of credit contracts. They have spread and morphed in ways that Demchak never intended but always feared.

Long celebrated as a way for banks to diffuse their risks, the credit derivatives invented by Demchak's team have instead multiplied them. The new credit vehicles encouraged banks and other financial firms to take on riskier loans than they should have; helped increase leverage in the global financial system; and exposed a much wider array of financial firms to the risk of default. (View an interactive timeline of derivatives.)

Credit derivatives aren't, of course, solely to blame for the pandemic that has helped bring down Wall Street. They didn't single-handedly force Bear Stearns and Lehman Brothers to bulk up on toxic debt, dooming them to collapse. But they made the financial world more complex and more opaque. Ultimately, they have exacerbated the market panic, as financial firms and regulators have belatedly come to grips with the enormity of the problems. Merrill Lynch ultimately capitulated to a sale because investors had no confidence that the firm had a handle on what its problems were. When the federal government took over A.I.G. in September, it was largely because of the insurance behemoth's exposure to credit-default swaps, a type of derivative that flourished in the wake of Demchak and his team's creations. By mid-September, Treasury Secretary Hank Paulson was forced into proposing the largest bailout in U.S. history. Securities and Exchange Commission chairman Christopher Cox (S.E.C. No Evil, October) called for regulating credit derivatives.

Morgan's derivatives project began in the wake of the Asian financial crisis in 1997 as an attempt to protect the bank from bad loans. Demchak's innovations worked—for his bank. Morgan came to dominate this corner of the financial world while preserving a culture of prudence. Morgan—deemed to be so safe that it snagged two of the victims of the financial-system collapse, Bear Stearns and Washington Mutual—is still swimming in credit derivatives, far more than any other firm on Wall Street, though the

bank says it's hedged. As of the second quarter of 2008, the bank had written derivatives contracts backing credit valued at \$10.2 trillion, roughly three-quarters the size of the U.S. economy.

But Demchak's innovation has a more troubling legacy. J.P. Morgan, rather than being inoculated, was actually becoming the Patient Zero of Wall Street, eventually carrying the credit virus to the far corners of the global financial system. The structure of the first derivatives deal wasn't as solid as Demchak's team had intended. That initial, flawed financial instrument was later replicated thousands of times by J.P. Morgan and other banks, with the same defects repeated and magnified over and over again.

The creation of credit derivatives, only a decade ago, is more responsible than anything else for binding the global financial world together more closely. Now some of the trailblazers are puzzling over what has been wrought. "How can we have a financial system so precariously balanced after such an extraordinarily profitable period?" asks Andrew Donaldson, a former colleague of Demchak's who runs an asset management firm in London.

Demchak spends his days in an unassuming office in PNC's headquarters, situated amid a slightly seedy collection of streets in downtown Pittsburgh. Demchak warned for years about excesses in lending and is now baffled by, and even somewhat contemptuous of, his peers' disastrous mistakes: "At the end of the day, I'm never going to be—knock on wood—a guy you see in the paper and say, 'Look at this stupid, self-serving decision.'"

Later, as he thinks back to 1997 and the days in New York when his team helped get the derivatives market off the ground, he lights up. "Oh, God," Demchak says. "It was absolutely the best time ever in my life."

In the mid-1990s, Demchak, along with his boss, Peter Hancock, an effervescent Briton, became converts to the closest thing the banking industry has had to a religious reformation. Back then, relationships drove the commercial-banking business. Glad-handing bankers with tight connections to corporate boardrooms made the rain.

These guys never met a loan from a corporate client they would turn down, even if they weren't sure it would be profitable in the long run.

Hancock and Demchak's creed was simple: Banks should know whether their loans were going to make money. The pair insisted that loans be priced to their current value in the market. Because of the legacy of the old relationship bankers, J.P. Morgan was struggling. The problem, in the view of the stock market, was that the bank had the wrong clients. They were sleepy American icons, some of whom John Pierpont Morgan himself had lent to and even helped build. Though bank officials were promising Wall Street that it could generate returns of 20 percent, the return on many of its loans was much lower, forcing the bank to run the race while dragging lead weights on its ankles.

The Asian financial crisis highlighted the problem. Morgan lost money on loans to Asian companies. That prompted the bank to take a look at all of its corporate lending practices, abroad as well as at home. When it did, top executives came to a sobering realization: Not only was J.P. Morgan not making nearly enough profit on these blue-chip corporate loans, the bank had also made far too many of them. Most weren't loans at all but lines of credit promising funds at some later date. Hancock and Demchak realized that in a crisis, many of these companies would probably ask J.P. Morgan for access to the money they were promised. Worse, they wouldn't do it unless they were on the brink of collapse—exactly the wrong time for a banker to make a loan. The bankers who made those loans thought the odds of that happening were too small to even consider. "The old banking mentality viewed them as riskless," Demchak says. But the mentality was wrong.

Morgan realized it needed to act quickly to reduce its exposure. It had to free up capital for more profitable business. But it couldn't sell the loans without alienating its longtime, blue-chip customers.

Demchak put the new religion into action. "Demchak was the first person I know of who had the vision

that the credit-derivatives market could be anything like it is today," says Charles Pardue, who worked for Demchak at J.P. Morgan before moving to a hedge fund in London.

Over the coming months, Demchak would put his assault team of math whizzes and marketers to work on fixing the problem. Within the bank, the project was called the Credit Transformation.

Demchak received crucial help from his lieutenant, Blythe Masters, a rising star and formidable presence at the bank. She interned at Morgan while still in college at Cambridge, in Britain, and joined the bank after graduating. Ultracompetitive and driven with a passion for debate, she would give talks and seminars proselytizing about the promise and power of credit derivatives, ultimately becoming their "poster child," according to credit-markets consultant Eileen Murphy.

"When you are doing something new, it gets done only by imposing your force of will," says a former colleague of Masters'. "She was that person."

Wall Street likes to call its innovations "technologies" to convey a weighty sense of importance. What Demchak and Masters did was combine two of these technologies—securitization and credit derivatives—for the first time.

Securitization has been around since the 1970s. In such a transaction, a group of loans—for example, mortgage, credit card, or corporate loans—is bundled together and sliced up into pieces called tranches. The lowest portion, called the equity, is exposed to the first losses. The next slice up is exposed to the following losses, and so on, until you get to the top. The slices are usually rated by the rating agencies. (Often, the media and even some on Wall Street colloquially refer to tranches of securitizations as derivatives; they aren't. Tranches are securities backed by a pool of cash-producing assets.)

The Demchak group's breakthrough was to inject a little magic into standard securitizations. Instead of putting a particular loan into the sliced-up instrument—say, a 30-year loan to I.B.M.—it put a piece of J.P. Morgan's exposure to I.B.M. into it. For this, the team used credit-default swaps, a burgeoning form of credit derivative. In a C.D.S. transaction, the buyer is protected against a default. These contracts had been floating around in small, experimental form for several years, having been created by Bankers Trust, a scrappy cowboy investment bank.

Demchak's team was the first to take them wholesale, using credit-default swaps in a huge deal. They mashed up J.P. Morgan's exposure to more than 300 giant corporations, created an off-balance-sheet vehicle, then sold slices of that to investors. The vehicle then protected J.P. Morgan from defaults. In effect, Morgan was paying insurance premiums to investors who now were on the hook if one of Morgan's clients went belly-up. "The innovation of not being tied to specific loans or bonds is what made the credit-derivatives market what it is today," says Romita Shetty, who was part of Demchak's team at J.P. Morgan.

Development on the project continued slowly through the second half of 1997, involving painstaking and tedious legal and accounting work, quantitative analysis, and hand-holding and persuasion of banking regulators and credit-rating agencies. Demchak and Masters wanted their first deal to hit the market by the end of the year so that Morgan could get credit for it when the bank reported its earnings. The period was so intense that Masters, an avid equestrienne, at one point took a conference call from atop her horse.

Finally, in December 1997, Demchak's team closed on this first big credit-derivatives deal, the Broad Indexed Secured Trust Offering, or Bistro for short. Insurance companies and banks, the initial customers, were enthusiastic, snapping it up in just two weeks. The deal was enormous for the time, off-loading more than \$9.7 billion of J.P. Morgan's exposure. Morgan had succeeded in reducing its balance-sheet risk and was able to free up capital to buy its stock back.

J.P. Morgan would go on to launch a credit-derivatives assembly line, becoming the Henry Ford of the new financial market. Throughout the 1990s, the bank was a major player in persuading lawmakers to

allow the derivatives markets to remain unregulated—a move regulators are now reevaluating. Bistro helped J.P. Morgan traders in London kick-start the expansion of the “single-name” C.D.S. market, where individual contracts that cover just one company or entity trade hands. This market became liquid and deep by the early 2000s. “We had 100 people,” Demchak recalls. “We helped create the regulatory framework, the legal and accounting framework, and we did billions. We industrialized the product.”

J.P. Morgan continues to dominate the world of derivatives. It has derivatives contracts tied to \$90 trillion of underlying securities. Of that, \$10.2 trillion are credit-derivatives contracts. Those mind-boggling totals are somewhat misleading. They reflect what is called the “notional” amount in the world of derivatives, based on the underlying amount of the contract, not its current value. When offsetting contracts are taken into account, that figure is whittled down to a much smaller—though still enormous—\$109 billion of derivatives, of which \$26 billion are credit derivatives. That’s the amount the bank could lose if all its trading partners went out of business, an extremely remote event. But the exposure is climbing, up 17.4 percent from the end of 2007. That’s equal to 20 percent of the bank’s net worth.

Bistro “was the most sublime piece of financial engineering that was ever developed. It was breathtaking in terms of beauty and elegance,” says Satyajit Das, a risk consultant and the author of *Traders, Guns, and Money*, a financial history. But “in many ways,” Das adds, “J.P. Morgan created Frankenstein’s monster.”

For J.P. Morgan, Bistro worked wonderfully. But even in that first deal, the weaknesses in structured finance and credit derivatives that would come to the fore in the 2007 credit-market crash were already there.

Despite its blue-chip assets, Bistro didn’t perform pristinely. The initial slice, the equity layer that Morgan retained as a cushion against trouble, was so thin that it couldn’t weather even one default from one of the bigger companies in the bundle. That ultimately happened, wiping the slice out entirely. The investors who were one notch up, in what’s called the mezzanine layer, lost money as well. Even the buyers of the top-rated tranches, which were thought to be rock solid, had to endure bumpy periods before they got their money back.

During that first major deal, the credit-rating agencies, which were supposed to be impartial, were already deeply enmeshed in the give-and-take of the process. A former Morgan banker who helped create Bistro recalls that Standard & Poor’s was giving the bank a tough time. The rating firm would run the deal through its models, and “each time, it came up with disastrous results. We did some tinkering and all of a sudden, it could rate the deal,” the banker says.

The pattern was set. The rating agencies would become integral to the creation of the structures. Standard & Poor’s says questioning that first deal was appropriate and stands by its original rating. It further says it doesn’t get involved in structuring deals. But the close relationships between the rating agencies and the Wall Street firms were heavily criticized following widespread mortgage-related securities failures after the housing bubble burst.

After Bistro, investors and regulators embraced derivatives as ways to free up capital to make more loans. Banks around the world used the structures to off-load their own credit risk. Competitors rushed to copy Morgan and Bistro.

The knockoffs and followups were even more flawed than the original model. The second Bistro deal, in 1998, suffered credit downgrades. One of the big deals that followed fast on Bistro’s heels was York Funding, a Credit Suisse structure. “They stuffed it with the worst possible credits,” recalls a former rating-agency employee who examined the deal.

One major problem was that banks had the ability to substitute loans in and out of the structure, as long as the loans had the same credit rating. This allowed managers to scour their books for a loan that looked shaky but still retained a good credit rating and swap it in for a healthier one. The tranche’s credit rating would remain the same, making the whole deal look better on paper than it actually was.

Ultimately, the game became less about reducing risk and more about fooling regulators and the rating agencies. "From 1999 to 2000, there was a lot of innovation for innovation's sake. A lot of products game the rating agencies and game the regulatory capital requirements," says a former J.P. Morgan banker who was involved with Bistro.

Warning signs piled up. After the tech bubble burst in 2000, myriad similar deals performed terribly. Some were backed by corporate loans. Many were Bistro-like constructs with credit derivatives. As a class, they hadn't made it through a cycle of corporate defaults profitably, the acid test of any stable credit product. In his recounting of the period, Das writes, "The credit models failed miserably."

Despite the obvious failure of the first round of this wizardry, Wall Street was at it again by 2003, this time with mortgages. Investment banks sold billions of structured securities, made up mostly of housing loans to subprime customers with shaky credit. As the market got going, Wall Street bundled leveraged loans made to companies that had junk ratings from the credit-rating agencies. At the peak in 2006, Wall Street issued \$89 billion worth of Bistro-like structures called synthetic collateralized-debt obligations. Many of the \$415 billion worth of the main type of C.D.O. carried embedded credit derivatives as well.

It's not surprising that they failed again. Investors and financial firms lost hundreds of billions of dollars as part of the housing and corporate loan meltdown. Only then did the credit-rating agencies come under assault for being too closely involved in helping Wall Street create the complex structures. It took until this year for the structured-finance market to come to a screeching halt.

Today, the financial markets are living in the slipstream of the Bistro deal. "People like to talk about what a shambles the banking system is. But it's a shambles by design. You are taking on capital, reserving some of it, and lending it out. The whole system is levered," says a former J.P. Morgan banker. After Bistro, it became more so.

The practice of crafting loans that banks had no intention of keeping on their own balance sheets wasn't invented by J.P. Morgan, nor was the credit-derivatives market solely responsible for making it possible. Certainly, not all the lending excesses, especially in mortgages, can be laid at the feet of the complex Wall Street structures that used derivatives. But Bistro spread the popularity of this "originate and distribute" model. This experience taught the banking industry that loans designed to be sold to investors for a quick profit performed much more poorly than loans that banks had to keep.

In addition to keeping the very small piece of Bistro's first-loss equity slice, J.P. Morgan retained part of the very top slice. Demchak's team christened it "supersenior." His group knew that there were risks, though slight, in keeping exposure to these slices. A.I.G., Merrill Lynch, and bond insurers MBIA and Ambac ignored them. Knowingly or not, these firms followed the Bistro deal, retaining supersenior exposure on their books to billions of dollars' worth of structures in recent years. These companies thought—erroneously—that the slices were so unlikely to default that they needn't set aside much capital for that eventuality.

The problem was that the underlying assets propping these slices up weren't blue-chip loans but rather loans to subprime borrowers and junk companies. The supersenior slices turned out to be enormously risky, exposing these companies to huge losses.

Bankers have lost their heads in the past several years. The financial system has run amok. When the federal government took control of mortgage giants Fannie Mae and Freddie Mac, the takeover was deemed a "credit event," triggering the credit-default swaps that other companies held as insurance against such an event. A week later, Lehman filed for bankruptcy, shrouding the market in an even greater fog. And then, investors in A.I.G. panicked. The insurance giant had written hundreds of billions of dollars' worth of protection on the supersenior slices of mortgage-backed securities. Because of its high credit rating, A.I.G. hadn't needed to post any initial collateral. But as the market sent the cost of default protection soaring, A.I.G.'s trading partners demanded collateral from the insurer. A.I.G. didn't have it. Credit-rating agencies downgraded the insurance company, requiring that it post even more collateral.

This left A.I.G. teetering on the edge of bankruptcy, and in an unprecedented intervention, it had to be nationalized by the federal government. For the first time, the C.D.S. market shrank in the first half of the year, after doubling every year since 2001.

Bistro had tied the world together, taking credit risk from the banks and passing it on to anyone who wanted it. For years, proponents of credit derivatives, including then-Federal Reserve chairman Alan Greenspan and current chair Ben Bernanke, had celebrated the way they spread risk. Everyone might share a little bit of risk, but no firm would collapse from it. Yet in this credit crisis, everyone has become infected.

You can almost detect a crisis of faith in Demchak. In the past eight years, he's seen one market failure after another. First came the Chase takeover of J.P. Morgan. Chase's stock soared in the '90s as investors credulously rewarded its growth. Although it was able to take over the languishing J.P. Morgan, Chase had exposure to almost every big blowup in the wake of the bursting of the 1990s stock market bubble. Much of Demchak's good work to off-load risk was for naught. (After Demchak left J.P. Morgan in 2002, almost every member of his team followed except Masters, who now runs the bank's commodities businesses and is regarded as a possible C.E.O. candidate one day.)

Then the credit markets ran wild, with bankers handing out loans that Demchak knew could never be profitable. Today, the markets are gripped with what he sees as an off-irrational panic, driving prices to fluctuate wildly.

Since Ronald Reagan's presidency, the dominant ideology governing the financial world has been what George Soros calls "market fundamentalism"—the belief that we should trust the market when deciding how to allocate our resources. We'll all be better off, the argument goes, if capital is allowed to flow wherever the prices call for it, with as little central planning and governmental interference as possible.

But we have had two great investment bubbles, first in the stock market and now in the credit markets. For the first time in a generation, even some bankers question whether the markets know anything. If they can't be trusted, what's going to replace them?

"I used to be the biggest advocate of marking everything to market at all times, because it keeps everyone honest," Demchak says, referring to the practice of recording the value on the books at the current value. But he saw markets overreacting, swinging from euphoria to pessimism. Now he thinks the fates of great companies are in the hands of inexperienced traders speculating in thin markets. A colleague complained to Demchak recently that "some 24-year-old kid is going to mark me down or up 100 million bucks today. How is that?"

Demchak understands his colleague's frustration. "He is right."