

100 BEST GLOBAL BRANDS

BusinessWeek

WHAT SANK
WALL STREET

SIZING UP THE
FED'S ARSENAL

INSIDE AIG'S
COLLAPSE

HOW TO PLAY
THE CRISIS

IS IT SAFE YET?





WALL STREET STAGGERS

We should have seen it coming: Easy money, hasty deregulation, and arcane derivatives have brought financial calamity before. As the markets begin to dig out of the muck, what have we learned? And will we recognize the warning signs next time? **IBW** | [PAGE 28](#)

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DESPERATE DAYS IN THE CANYONS OF FINANCE

In the same week that yet another hurricane clobbered the Gulf Coast, the howling winds on Wall Street hit 150 miles an hour, and the news flew so fast it was hard to catch a breath. On Sept. 15, **Lehman Brothers** went under, with **Barclays** paying a bargain \$1.75 billion for the choice parts of the firm two days later. But the truly earth-shaking event was the **Fed's** \$85 billion bailout of giant insurer **AIG** on Sept. 16, after it became clear that the private sector couldn't raise the needed capital and a collapse would be catastrophic. The Fed, declining to panic, held its key rate steady at 2%. But the Dow plunged

7% from Sept. 15-17, and the depth of lingering fears was highlighted by the price of gold, which went from \$780 to \$869 on Sept. 17. At press time, only two large independent investment banks were left on the Street—**Goldman Sachs** and **Morgan Stanley**—but it seemed Goldman might soon be the last man standing. Both firms on Sept. 16 reported profit drops that actually beat analysts' expectations, but that didn't stop investors from stampeding. By the close of trading on Sept. 17, their shares were down 15% and 32%, respectively, and Morgan, fearing for its life, was said to be deep in merger talks with **Wachovia**



Back in March, we noted that Bernanke was marching into unknown territory



An AIG staffer on the day the Fed put together the \$85 billion bailout

and at least one other bank. The other house that appeared in imminent danger, **Washington Mutual**, on Sept. 17 won a concession from its biggest investor that would allow it to raise capital, lop off branches, or sell out entirely.

| BW | PAGE 028 "Wall Street Stagers"

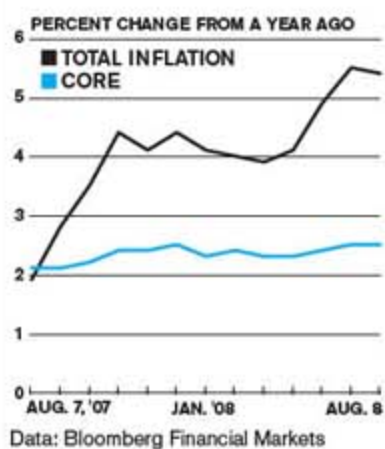
STOP NAKED SHORTS!

It may be a classic case of shutting the barn door, but the SEC on Sept. 17 issued a rule targeting "naked shorting," in which investors sell shares they don't own without even arranging to borrow them first. The rule, effective immediately, requires shorts to deliver shares to buyers within three days; the agency also finalized two narrower rules limiting the practice. Some see naked shorting behind the failures of **Bear Stearns** and **Lehman Brothers**, but critics question how widespread the practice really is and say a temporary rule that expired in August, protecting just 19 financial firms, encumbered legitimate investors.

'BREAKING THE BUCK'

So much for safe havens. On Sept. 16, the **Reserve Fund** announced that hundreds of millions of dollars in debt securities issued by **Lehman Brothers** and owned by its money-market **Primary Fund** were worthless. The result: The fund's net asset value fell from \$1 per share to 97¢. It was only the second time in history that a seemingly safe money fund—a form that Reserve's founder helped invent more than

INFLATION ABATES



30 years ago—had "broken the buck." Could other such funds follow? At **Evergreen Investments**, parent **Wachovia** announced it would prop up the value of three money funds so they wouldn't crater along with Lehman debt.

RUSSIA'S MELTDOWN

Somewhere in communist heaven, Marx and Lenin must be chuckling. But that will be little consolation to today's capitalist Russia, caught in the bitter winds from Wall Street. On Sept. 16, Moscow's **MICEX** exchange fell by a staggering 17.5%. The next day, regulators suspended trading on the two main bourses. The debacle follows weeks of slumping prices—not helped by the foray into Georgia in August. Russia's market has tanked by almost two-thirds since early July, wiping out \$750 billion in equity value.

| BW | PAGE 048 "Russian Stocks in Free Fall"

DEUTSCHE STRIKES

German bankers are falling back in love with those middle-class depositors they

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008 NEWS YOU NEED TO KNOW



HP's Mark Hurd:
The company
will lay off nearly
25,000 but hire
12,000

have taken for granted in recent years. **Deutsche Bank** agreed on Sept. 12 to pay \$4 billion for a 30% stake in **Deutsche Post's Postbank** unit, which offers services to customers at post office counters. The deal, the first step on the way to acquiring a majority, marks a return to roots for Deutsche, which has spent the past decade building a global investment banking business. It comes less than two weeks after **Commerzbank** bought **Dresdner Bank**.

POISONED MILK IN CHINA

It was bad enough when the deadly chemical melamine was found in pet food exports from China last year. Now it's turning up in Chinese baby formula, apparently added by unscrupulous dealers because it falsely boosts protein levels in milk on tests. Contaminated powdered milk had killed at least three infants and caused illnesses in 6,244 children as of Sept. 17.

▶ "Chinese Again Victimized by Poisoned Products"
businessweek.com/magazine

LAYOFFS AT HP

The announcement came as a shock, especially with the financial markets in crisis: **Hewlett-**

Packard said on Sept. 15 that it will cut 24,600 jobs. But here's the glass-half-full part: The cuts will come over three years in the process of integrating technology outsourcing outfit **Electronic Data Systems**. About half will come in the U.S. And HP said it would hire 12,000 workers over the same period as it beefs up its business of managing companies' IT needs.

▶ "HP to Cut Nearly 25,000 Jobs"
businessweek.com/magazine

NO DEAL FOR TAKE-TWO

Electronic Arts made another U-turn in its pursuit of the maker of smash franchise *Grand Theft Auto*—and this one

could mean "game over." EA, one of the largest independent video game publishers, said on Sept. 15 that it had ended talks to acquire **Take-Two Interactive**. With the \$2 billion offer off the table, Take-Two says it plans to explore "strategic alternatives." EA is betting it can boost profits without taking on extra debt, thanks to its new world-building game, *Spore*, and more than a dozen other titles due in the next six months.

▶ "EA Abandons Pursuit of Take-Two"
businessweek.com/magazine



Electronic Arts won't get its hands on Take-Two's *Grand Theft Auto*

TO HECK WITH GREEN

With consumers feeling blue, companies are dialing back on green marketing. In a survey of 72 companies by **Duke University's Fuqua School of Business**, chief marketing officers ranked environmental issues lowest on a list of five priorities over the coming 12 months. Even **Wal-Mart**, which has beaten the sustainability drum in recent years, is going easy. Green issues were mentioned in 12 of its press

\$441 billion

Nominal value of credit default swaps insured by AIG

Data: Bloomberg Financial Markets



Taking tainted baby formula off the shelves in China. Three infants have died



Wreckage in Galveston: Ike left behind some \$16 billion in damages

releases in the year through Sept. 11, compared with 29 during the same period last year.

Advertising Age

A JOLT FROM THE VOLT

General Motors wrapped some steel around the hype it has generated for its **Chevrolet Volt** electric car on Sept. 16, when it rolled out the production version of the green machine at its 100th anniversary event in Detroit. The Volt will arrive in showrooms in late 2010. It will be able to go 40 miles on electric drive before a gasoline engine kicks in to recharge the battery. Some critics carped that the production model had lost some of the edgier styling that wowed the crowds at last year's Detroit Auto Show.

"GM Charges Up the Electric Chevy Volt" businessweek.com/magazine

GOOD CHEMISTRY?

The global financial system may be trembling, but the urge to merge runs strong—especially in fast-consolidating industries. German chemicals giant **BASF** on Sept. 15 made a \$5.4 billion friendly offer for Swiss specialty chemicals maker **Ciba**. BASF even found banks willing to lend it money for the deal. The combined company will be the world's top supplier of chemicals to the paper industry. Elsewhere on the deal front, **Samsung** on Sept. 17 made public a \$5.8 billion offer for flash-chip maker **Sandisk**, which spurned the bid as inadequate.

IKE'S IMPACT

Hurricane Ike slammed the Texas and Louisiana coasts on Sept. 13 and then rampaged across the Midwest, causing an

estimated \$16 billion in damages. Some 1.3 million barrels of daily oil production, already shut down because of **Hurricane Gustav**, stayed down. But oil traders shrugged that off, and futures prices continued their recent swift fall. Oil sank as low as \$90.51 a barrel on Sept. 16 before firming a bit on Sept. 17. Traders are focusing on the bigger picture: Wall Street turmoil, economic gloom, and signs of dissension in **OPEC**. The Saudis have signaled that they don't feel bound by production cuts agreed to by the cartel on Sept. 10.

\$2.8 trillion

Estimate of the market value of global stocks wiped out between Sept. 15 and Sept. 17

Data: Bloomberg Financial Markets

HARVARD SCORES AGAIN

How in heaven's name does Harvard do it? The university's \$37 billion endowment fund, known for racking up super-rich returns, posted a gain of 8.6% for the year ended June 30. The fund far outperformed most other large college funds, which lost 4.4% on average, and walloped the S&P 500, which dropped 13.1% in the same period. The fund relies on a bevy of unusual investments, ranging from hedge funds to timber forests, to maintain its scintillating performance.

THE HIGH COST OF NATO

Membership in NATO has its privileges, but it also carries a steep price. **Romania**, a member since 2004, is gearing up to make its biggest military equipment purchase ever: 48 fighter jets, reports *BusinessWeek Romania* in its Sept. 23 issue. Companies including **Alenia**, **Lockheed Martin**, and **Saab** are set to bid on the estimated \$5 billion contract. And that's a fraction of the \$18 billion tab to bring Romania's armed forces up to NATO snuff, the government figures.





THE BAILOUT BALANCING ACT COULD WORK

The Fed and Treasury may be able to contain the credit crisis and spur a recovery if they dole out tough love and public assistance in just the right combination

By refusing to pony up more money to save Lehman Brothers, the U.S. government took a high-stakes gamble over the weekend of Sept. 12-14. After committing \$29 billion to the teardown of Bear Stearns and up to \$200 billion in the nationalization of Fannie Mae and Freddie Mac, Washington looked at the plight of Lehman and just said no. Yet, not two days later, the Federal Reserve gave troubled insurer American International Group an \$85 billion loan, effectively taking over the company.

Who survives and who doesn't? Those decisions could usher in the end of the credit crisis—or they might mark the end of any hope for an economic recovery next year.

This new uncertainty in the outlook reflects the cost of stepping back from moral hazard. Policymakers know that moral hazard—which arises when institutions don't bear the full consequences of their actions—can never be eliminated. Rather, they view the problem as a trade-off between the risk that government bailouts could encourage financial imprudence and the danger that without them, an event such as the failure of AIG could collapse the system. In the case of Lehman, the Fed and Treasury took a gamble that Lehman's failure could be a major step toward healthier financial

markets. As for AIG, the risk to the system was simply too great.

Events are still fluid, but the economic impact of these latest financial shocks should be modest as long as their ripple effects don't erode the capital bases of sounder institutions. Such a spillover, a big risk in the case of AIG, would severely crimp the availability of credit at a time when the economy is weak—partly as a result of already tight credit conditions.

The Fed is front and center in the efforts to contain the damage, not only to the financial system but also to the economy. It continues to treat the two problems with two different medicines: applying direct help for the credit market's woes via its innovative lending facilities and the broad power of interest rate cuts for the ailing economy.

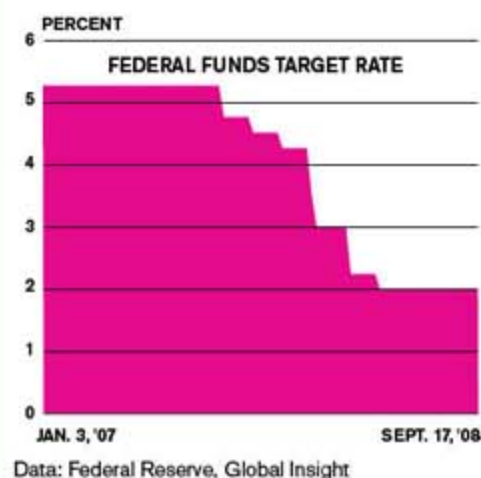
This two-pronged approach was clear from the Fed's failure to acquiesce to market desires for a rate cut on Sept. 16. It held its target rate at 2%, believing past rate cuts are sufficient to promote growth. Meanwhile, the Fed's lending programs, including additional enhancements on Sept. 14, are aimed at assuring liquidity at both depository institutions and investment banks. Those funds helped contain the wider damage from Lehman's fall, but those programs are not available to AIG because it is an insurer, not a bank. That they allowed Lehman to fail suggests policymakers felt they had sufficient liquidity in place to protect the system.

The new question for the Fed is how badly the latest upheaval will harm the economy by cutting further into the availability of credit to households and businesses. Companies will be even more hesitant to commit money to capital projects and new hires, and household balance sheets will take another blow from sagging stock prices. Even before the current storm, August reports on consumer spending, housing starts, industrial production, and employment showed the economy had already weakened further.

The Fed's Sept. 16 statement showed that policymakers were still seeking the right balance for its more traditional trade-off—the one between stifling economic growth and stoking inflation. While giving equal weight to those two worries, saying they were each “of significant concern,” the wording represented a sharp upgrade in angst about economic growth, compared with previous statements. The Fed appeared to leave the door ajar for a possible rate cut later this year, if the economy deteriorates further.

Optimally, the Fed's two-track efforts will at least lay the groundwork for both an economic recovery and stronger financial markets. And if policymakers' choices between moral hazard and tough love don't backfire, they will purge the system of weak financial players and promote a more realistic pricing of risk across all markets. Right now, though, that's a very big if. |BW|

THROUGH THE UPHEAVAL, THE FED HOLDS STEADY



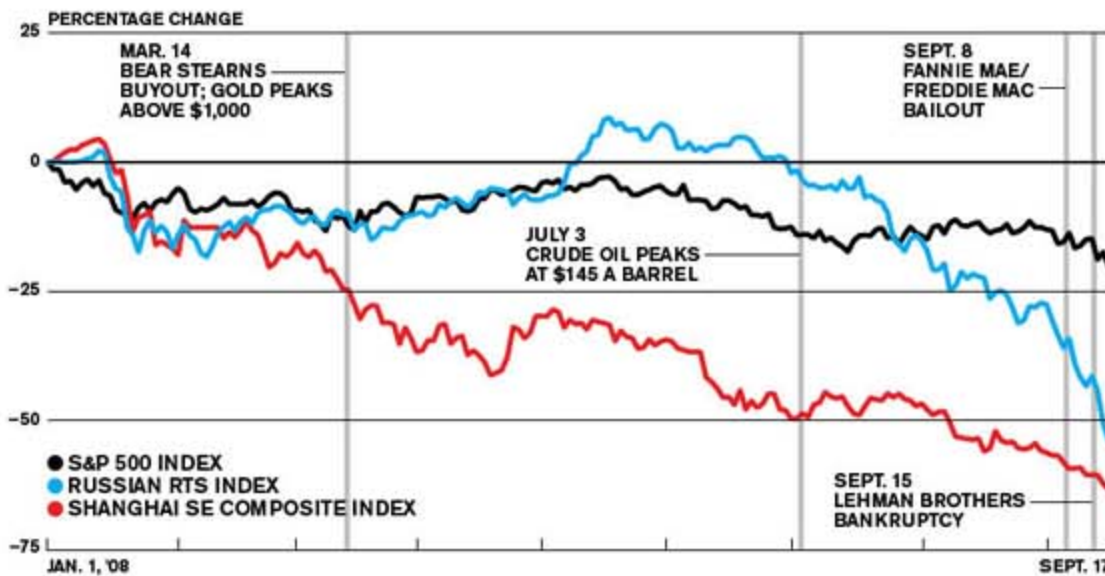
NUMBERS

GLOBAL MARKETS, FRIGHTENED INVESTORS

By Tara Kalwarski / Charts by David Foster

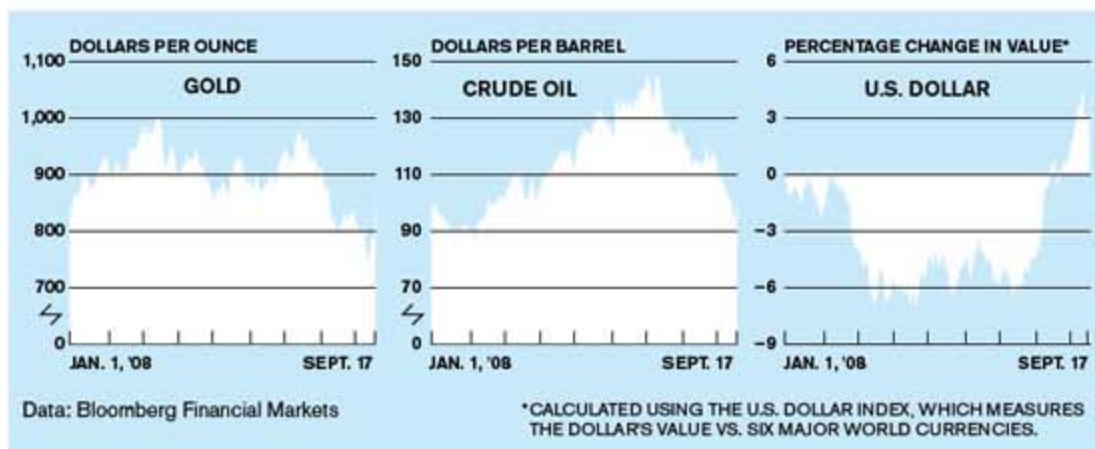
Bank failures and shotgun weddings on Wall Street have roiled global stock exchanges in recent weeks. The markets are experiencing a flight to quality as investors flee riskier holdings in favor of short-term Treasuries—and gold. On the upside, oil is down from its all-time high, and the dollar has strengthened.

Global Equity Markets: Although the S&P 500 has lost more than 20% of its value, major indices in Russia and China have suffered bigger blows this year.



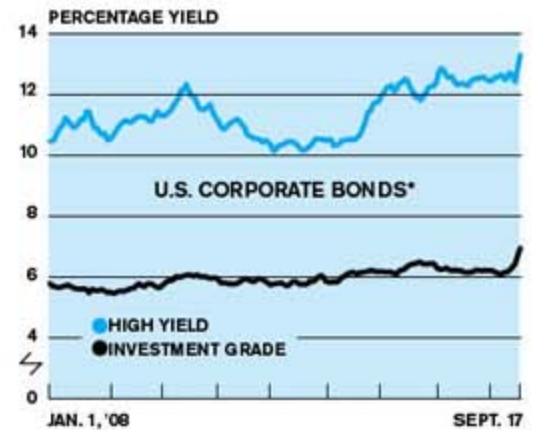
GOLD, OIL, AND THE DOLLAR

Crude oil remains well below its peak in July, while gold spiked in mid-September. The U.S. dollar is up for the year against six major currencies.



CREDIT CRUNCHING

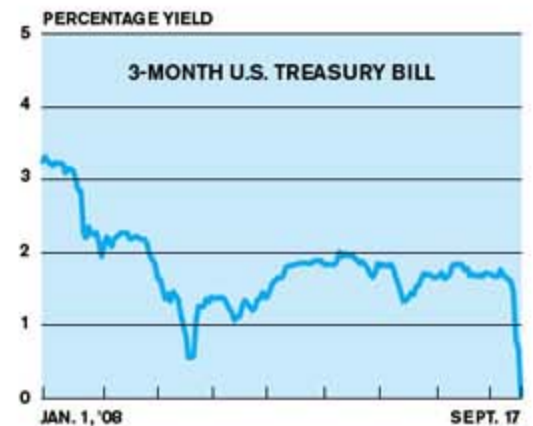
Corporate Bonds: The premium on high-yield bonds has increased substantially since early summer.



*AS MEASURED BY THE FINRA-BLOOMBERG ACTIVE U.S. CORPORATE BOND INDICES

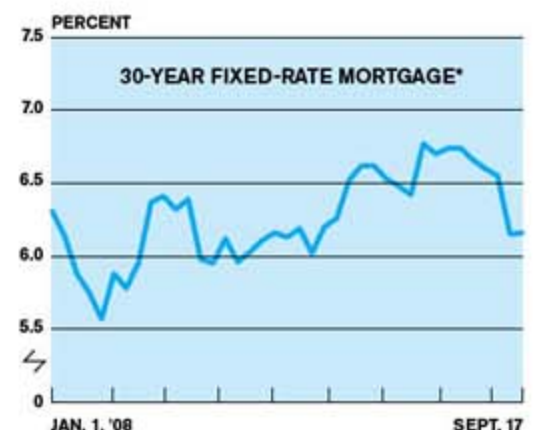
Data: Bloomberg Financial Markets

Treasuries: A flight to quality has sent the yields on short-term Treasury bills plunging.



Data: Bloomberg Financial Markets

Mortgages: The interest rate on 30-year, fixed-rate mortgages has declined slightly over the past few weeks.



Data: Bankrate.com

*NATIONAL AVERAGE

WILL WE EVER LEARN?



In the '90s, the smartest people were telling us that the Internet Revolution had vanquished the business cycle by sending productivity on a perpetual upward climb. Etoys and Pets.com were in their glory. Economic laws no longer applied. And then the bubble burst.

In the '00s, the smartest people were telling us that Wall Street had vanquished the business cycle by gaining mastery over risk.

No mortgage was too absurd, no leverage too great, no structured product too reckless when risk-spreading models were so brilliantly engineered. Commonsense laws no longer applied. And then the bubble burst, again. ¶ So the big question, as we absorb what's happened to Freddie and Fannie and Lehman and AIG and Merrill and, oh yes, Bear Stearns, is this: Do we have the capacity to learn? Despite temptation, can we



Treasury Secretary Paulson fielding questions on Sept. 15

(FROM LEFT) BRAD TRENT; J. SCOTT APPLEWHITE/AP PHOTO

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resolve to assume that if something sounds crazy, it probably is? The business cycle is real. The economy has some direct relationship to supply and demand. Housing, which has grown at roughly the rate of inflation for many decades, probably can't grow a whole lot faster over time. You can't sustain a market based on lending when the borrowers don't have the resources to pay back the loans. It's all pretty basic. That guy on TV right now who's telling us how we can make a killing on real estate, with no money

down? We're probably better off resisting the urge to chase that particular dream.

In our coverage this week, we'll take you through the misconceptions and mistakes that led to the current crisis; assess what has to happen to get us on a safer footing; consider how long the Fed can keep riding to the rescue; and help make sense of the surprising calamity at AIG.

And, in the coming weeks and months, we'll continue to focus on the signs of whether we are—or are not—learning from our mistakes.

Stephen J. Adler
EDITOR-IN-CHIEF

HELLO
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EDITED BY DEBORAH STEAD



ANALYZE THIS

By Kerry Sulkowicz, M.D.

So much is written these days about teamwork and collaboration. But what about when you have to stand out by taking a stand? Some situations call for confrontation.

The best CEOs I work with know how to exert pressure, say no, and start and win a fight when necessary. So much for teamwork? Actually, collaboration and confrontation aren't mutually exclusive. There's aggression—a basic survival mechanism—and then there's its tamer, more socially adaptive cousin, assertiveness, which can be deployed usefully, including with people working on the "same side."

The need to be assertive comes up all the time. It's essential in

negotiating contracts, rejecting bad work, criticizing a strategy, or firing (or defending) an employee. Yet some people will do almost anything to avoid confrontation. Why? They may fear that expressing any displeasure will open the floodgates of their own anger. Or they may have been raised to regard aggression as dangerous or shameful, and to see criticism as hurtful. Confidence and character play a role, too. After all, you're likely to be held accountable if you take a strong position and win.

There are prices to be paid for fleeing the good fight: everything from hours of correcting underlings' work (rather than sending it back) to being perceived as a weak leader who tolerates mediocrity. Of course, too much confrontation—or yelling just to vent frustration—won't work, either. If that's your habitual response, you'll be seen simply as disagreeable. (Overly aggressive people use confrontation as a form of armor.)

The key, oddly enough, is to empathize with the person you're confronting. To that end, marshal useful facts rather than impressions, offer alternatives along with your objections, and limit comments to the deed, not the doer. Your opponent won't hear anything you say after an attack on his or her character. And don't be self-righteous. Or gloat if you prevail. Nobody likes a poor winner.

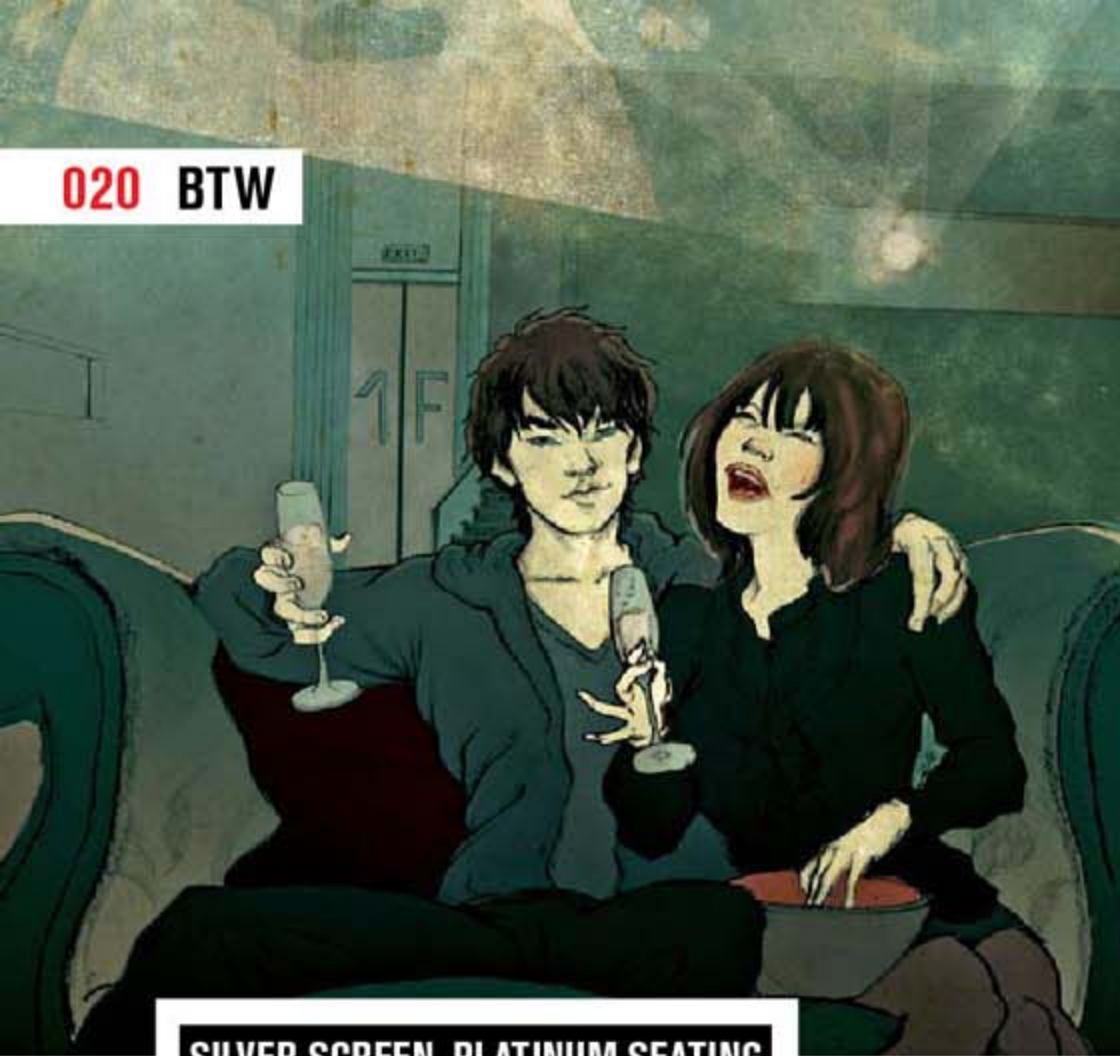
Kerry J. Sulkowicz, M.D., a psychoanalyst and founder of Boswell Group, advises CEOs on psychological aspects of business. Send him questions at analyzethis@businessweek.com.

NOW: BEAUJOLAIS PLASTIQUE

Wine snobs now have another reason to turn up their noses at Beaujolais Nouveau, the newly pressed red wine that hits the market each fall after France's grape harvest. Boisset Family Estates, a leading exporter, says the Beaujolais it ships to the U.S. this year will come in plastic bottles. Now a case will weigh 22 pounds, down from 38—a big savings in jet fuel consumption. Beaujolais rival Georges Duboeuf hasn't yet gone plastic. But France's Champagne trade group is also looking to lighten up. It just put a test batch of 2.5 million bubbly bottles made of thinner glass in the cellars of G.H. Mumm Champagne, to be monitored for a few years. "We want to be sure that the lighter glass stands up to pressure and doesn't change the taste," says a trade group spokeswoman. —Carol Matlack in Paris

To save on shipping costs, a leading exporter is dropping glass bottles





SILVER SCREEN, PLATINUM SEATING

With a plethora of new movie theaters to compete with, some of Tokyo's multiplexes are trying to raise their profile by increasing their cachet. In July, theater operator Shochiku introduced two private viewing rooms at its Shinjuku Piccadilly cinema. For \$280, two people—celebrities craving privacy, maybe, or a couple enjoying an anniversary—can watch the latest film in one of two private spaces outfitted with Italian sofas and top-notch audio systems. Customers, who enter and leave by private elevator, also get free Champagne and snacks as they watch such hits as *20th Century Boys*, based on a smash manga series. For those who can't afford the private digs (which are popular, but not selling out, Shochiku says), there are \$47 tickets for posh "platinum seats" at the Piccadilly, with access to the multiplex's upscale café. —Ian Rowley and Hiroko Tashiro in Tokyo

THE LITTLE ELECTRIC CAR THAT MIGHT

What seats two adults, plugs into a wall socket, and costs less than 2¢ a mile to drive? The REVA, a tiny vehicle that may be the unlikely leader in the world's electric vehicle market. Its maker, Bangalore-based REVA Electric Car, has sold nearly 3,000 of the autos (most marketed as a second vehicle) in India and Europe—1,000 in London alone, where drivers of the \$9,000-to-\$11,000 G-Wiz, as it's called in Britain, are exempt from paying the \$14-a-day congestion fee to enter the city's center. The vehicle has limits: Its interior feels cramped, its body consists mostly of plastic polymers, and it was obliterated in a 40-mph crash test conducted by Britain's *Top Gear* magazine. "It's technically a quadricycle," says independent auto designer Stephen Clemenger. REVA's chief technology officer, Chetan Maini, says the car isn't meant to be driven fast. Now developing roadster and pickup models, he seems undaunted by the demands of ramping up output—including investment in more automated production lines—and the specter of competition. India's Tata Motors and Mahindra & Mahindra plan their own electric cars, and U.S. and Japanese giants are pouring money into research. "We were the first ones to get here," Maini says. "We can stay in the lead." —Mehul Srivastava in New Delhi



Some London commuters drive REVAs to escape the city's costly congestion fees



A new study says senior facilities vary in quality, but ownership isn't the issue

PRIVATE EQUITY NURSING HOMES: NOT SO SICK

Nearly half of the largest U.S. nursing home chains were bought by private equity firms in the past decade. Press reports last year suggested these owners have focused more on the bottom line than on quality care, prompting congressional hearings. Now two policy professors at Harvard Medical School say those worries were overblown. Indeed, they conclude, for 7 of 9 criteria—including weight loss and restraint use—such nursing homes improved more than their nonprofit or for-profit counterparts. In looking at quality issues, the researchers took into account local conditions such as nursing shortages in certain cities. "The main issue is not private equity," says co-author David Stevenson. "There are instances of poor quality everywhere." —Arlene Weintraub



Japan's not ready to rest in peace

AN ECONOMY PRIMED FOR FOREIGN INVESTMENT

Despite reports to the contrary, Japan's economy is still very much alive. For the past 10 years, economists have been predicting the demise of Japan's economic power, but every year Japan forges ahead, thanks to several constants, including: 1) It is the second largest economy in the world, 2) Stable growth, 3) A sophisticated, high-tech infrastructure, and 4) A lively influx of foreign capital.

Consider the facts. Japan's gross domestic product can be counted on for 2% annual growth (for the last five years and running), and Japan's GDP accounts for 10% of the world's economy. It is widely accepted that Japan is a technology-focused country, but in addition, Japan's infrastructure is ranked among best in the world in terms of business sophistication (based on research by the World Economic Forum).

Those factors make Japan an attractive market for foreign investors, and, in fact, direct foreign investment to Japan has increased every year since 1998. Last year, foreign investment grew by ¥2.3 trillion (approximately U.S.\$21.3 billion), the largest annual increase in five years.

Three areas that are currently attracting the most attention from investors, both foreign and domestic, are biotechnology, information and communications technology (ICT) and the automobile industry.

Thanks to deregulation of the industry, featuring a major overhaul of Japan's pharmaceutical laws to welcome foreign competition, Japan's biotechnology market is expanding while the whole industry is enjoying vigorous growth. And thanks to the aging of the population in Japan and other countries around the world, the market is likely to enjoy steady growth for years to come.

One major foreign player in the industry is Johnson & Johnson, one of the world's best-known names in healthcare. Johnson & Johnson has a multifaceted operation in Japan, employing more than 2,500 people and spanning consumer products, pharmaceuticals and healthcare supplies. Johnson & Johnson is also a respected local partner, thanks to relationships with Japanese companies, including a longstanding partnership with Shiseido, Japan's leading cosmetics firm. The two companies are now jointly developing hair and skin care products.

Japan has even become a global R&D center for Johnson & Johnson, as several products originally developed in Japan for the Japanese market, have been exported overseas, including the Waterblock Band-Aid bandages, design to keep cuts and abrasions dry, and the Powerbrush, a battery operated toothbrush.

Japan's massive ICT industry includes six market segments: mobile phone services, IC cards and radio frequency ID technology (RFID), visual communications, online marketing, games, and public services. Today, ICT is the country's largest industry in terms of market scale with a value of 120 trillion yen (based on 2005 research). And Japan features some of the world's fastest broadband connection speeds and the highest internet penetration rates as well as the world's most advanced integrated mobile communication and IC payment services.

Such a lively technology environment made Japan an ideal testing ground for U.S. communications giant, Cisco Systems, which opened a new R&D center in Tokyo in 2005 and employs more than 1000 people in Japan. Their Tokyo team is focused on routing, multicasting, wireless technology and Internet Protocol Next-Generation Networks (IP NGN).

In 2006, at the invitation of one of Japan's largest communications companies, NTT, Cisco was invited to participate in a field trial for a commercial, next-generation network service that is likely to be essential to the advanced information networks of the future.

Japan's automobile industry, led by the world's largest automaker Toyota, has always been the shining star of the country's industrial complex. And opportunities abound for foreign companies who are willing to adapt to Japan's unique market structure.

Bosch, a global powerhouse in automotive goods and building technologies has actually been selling electrical automotive equipment to Japanese companies since 1911. Bosch's Japanese subsidiary was founded in 1985, and today the company employs 9,000 people and develops, imports and sells fuel-injection systems, transmission components, security systems and a full range of automotive components to customers in Japan and overseas.

These are only a few examples of the thousands of foreign companies finding success, forging partnerships and developing new products and technologies in the world's No. 2 economy. In biotechnology, ICT and many other industries, it's clear that Japan is committed to opening up markets, encouraging R&D and providing an ideal environment for foreign investment.



FACETIME

MARIA BARTIROMO



025



INSIDE A GAME-CHANGING WEEK ON THE STREET

Wall Street as we knew it died on Friday, Sept. 12, in a conference room at the Federal Reserve Bank of New York on Liberty Street in Lower Manhattan. There New York Fed President Tim Geithner, Fed Chairman Ben Bernanke, and Treasury Secretary Hank Paulson gathered the masters of America's battered financial universe to address the widening financial crisis and perhaps help engineer a bailout of Lehman Brothers. A chieftain who was in the room told me that as the power players put their cards—assets, liabilities, and fears—on the table on Friday and Saturday, the Lehman representatives “looked like zombies.” It was then that he realized they were done for and that even more devastating days lay ahead.

One Wall Street CEO who saw that future and acted fast was John Thain of Merrill Lynch. Thain almost immediately cut his losses and saved his shareholders by engineering a sale of his storied firm to Bank of America for about \$50 billion. Ken Lewis, the chief executive of BofA, later told

me that to pay for the acquisition of Merrill, even a dividend cut will be on the table when he meets with his board in October.

By Sunday, perhaps responding to pressure from conservative Republicans, the SWAT team from Washington laid out a tough-love position: The U.S. government would not be rescuing Lehman. That announcement, plus the Merrill-BofA shocker, set off one of the most tumultuous weeks on Wall Street in almost a century. In multiple interviews on CNBC, off the record, and for *BusinessWeek*, the mood I encountered was sheer gloom. One source said to me on Monday: “I wasn’t here in 1929, but I’m pretty sure it felt like what it feels like today.” And Lewis predicted: “The storm clouds are not going to go away until 2010.” But perhaps the most dramatic news was yet to come.

On Tuesday night the Fed forged a deal to lend up to \$85 billion to American International Group in exchange for a 79% equity stake—an effort to stabilize the reeling insurance

giant and help prevent the contagion in New York from devastating the U.S. economy and spreading overseas. The unprecedented agreement followed a tense day in which former AIG CEO Hank Greenberg, the ousted architect of the insurance and investment empire, reportedly sought to regain control. Instead, according to *The Wall Street Journal*, Paulson personally asked AIG CEO Robert Willumstad to step aside in favor of Edward Liddy, former boss of Allstate and a board member of Goldman Sachs, which Paulson once headed. "I've known Liddy a long time," Greenberg told me. "He knows the domestic casualty field, but that's not the same as a global franchise. This is nationalization." Larry Fink, CEO of investment firm BlackRock, which is 49% owned by Merrill and will now



Diamond isn't sure how many Lehman employees will be retained

ONE WALL STREET SOURCE SAID TO ME: "I WASN'T HERE IN 1929, BUT I'M PRETTY SURE IT FELT LIKE WHAT IT FEELS LIKE TODAY"

be part-owned by BofA, said: "There is a strong future for AIG."

As *BusinessWeek* went to press on Wednesday, deals at Morgan Stanley and Washington Mutual were in the wind—echoing what Openheimer managing director Meredith Whitney had suggested to me earlier in the week.

Besides Ken Lewis at BofA, one big winner emerging from the tumult was Barclays President Bob Diamond. After considering a buyout of Lehman, Diamond demurred. Now, Barclays is spending

\$1.75 billion for pieces of the fallen firm, including its M&A business and glitzy midtown Manhattan headquarters. I talked to Diamond on Wednesday afternoon.

MARIA BARTIROMO

Why did you do this deal? What are the big advantages?

ROBERT DIAMOND

Well, the first time we thought about this was six or eight weeks ago when it seemed clear that Lehman was having difficulty. But it just didn't seem realistic because I don't think we ever envisioned that we could do a transaction that would be value-enhancing, given that we both had big investment banks. I think a couple of things changed as we looked at it. One is that it wasn't obvious to me at first how complementary the businesses are. You have one business

that has huge scale and depth in the U.S., Lehman; and one that has huge scale and depth in Europe, Barclays Capital [Bar Cap]. Then because of the turmoil in the markets and the Lehman bankruptcy, the financial opportunity was completely different than anything we would've imagined.

And, of course, there's the real estate, the two data centers and the New York headquarters.

If you're going to take the broker-dealer, which is close to 10,000 people, you're going to have to put them somewhere. And they have a brand-new, first-class facility with all the technology and trading floors, and as part of the deal, we were able to include that.

Do you feel any guilt for not rescuing all of Lehman? Could that have helped quell this crisis?

We wanted to make sure that we didn't do anything that put Barclays at risk. That was first and foremost. And if it could lead to a transaction that could be good for our franchise and our shareholders, we were willing to pursue it, we were willing to be bold. We also felt it was important to be involved, whether it led to a transaction or not, because clearly the issues facing the regulators and the central bank were real.

So is that why you walked away from the whole firm?

Yes. We looked at the opportunity, and it was quite clear to us from the beginning from Paulson and Geithner that there was no appetite for federal money. So we knew that this was going to stand on its own or not happen.

Why not wait and buy Morgan Stanley?

I have no idea whether a transaction like that would make sense at all. This transaction really stood on its merits. So, I don't know, I never thought of it that way at all.

How many of the Lehman employees will you retain?

We actually don't know. We're hoping there won't be a significant reduction.

Do you feel like you're a survivor?

I talked to the Bar Cap team this morning, and the last thing I said was, "Thank you." It's because of the way that they have driven performance during the most difficult market environment we've ever seen—never taking their eyes off the clients, managing the risk, cutting costs. It's because of that that we have an opportunity in this turmoil to take advantage of—not to take advantage—but to invest in an opportunity such as we saw with Lehman. |BW|

Maria Bartiromo is the anchor of CNBC's Closing Bell.

By Paul M. Barrett
 Illustration by Chang Park

What brought down the markets? Bad choices, greed—and never learning from past mistakes

**WALL STREET
 IN CRISIS**

In times of high stress, many in the financial world seek solace in watery metaphors. We hear of vast irresistible forces converging in “perfect storms” and unforeseeable events contributing to “100-year floods.” ¶ How could we have expected, let alone prevented, this? ¶ Count on Warren E. Buffett to cut to the truth. Years ago, referring to reckless corporate debt, Buffett noted (or so the story goes): “You never know who is swimming naked until the tide goes out.” ¶ The tide’s moving, and we’re starting to get the full, not-so-pretty view. Along with the bare swimmers emerging from the soggy murk, we’re being reminded of some of the dumb ideas and reckless choices that helped deliver us to our current debacle. As stunning as the scene seems, we’ve actually had plenty of experience with this sort of thing. But like some stubborn residents of hurricane zones, we swiftly choose to



WALL ST.



STAGGERS

LESSONS NOT LEARNED

As Wall Street shudders again, a look at recent history reveals that an unchecked zeal to deregulate, combined with too-good-to-be-true financial stratagems, have led to a quarter-century of market turmoil

1982

Savings and loan deregulation, rationalized by Chicago School free-market theory, allows thrifts to gamble on more speculative lending



1985

Drexel Burnham Lambert's Michael Milken promotes "junk bonds" as a new way to finance business, promising that phenomenal interest rates will offset greater risks



2006

Lenders push adjustable-rate and subprime mortgages, while Wall Street and hedge funds create a housing bubble by bundling millions of risky loans and reselling them to investors

1986

S&L crisis intensifies, ultimately leading hundreds of thrifts, including Charles Keating's Lincoln S&L, to fail, largely because of bad real estate deals

2004

Federal Reserve Chairman Alan Greenspan, who earlier opposed tougher regulation of the financial derivatives that contributed to Long-Term Capital's demise, praises adjustable-rate mortgages and refinancing for ordinary homeowners



2007

Bear Stearns discloses that two of its hedge funds have lost most of their value, leading to the investment bank's 2008 fire-sale purchase by JPMorgan Chase



2000

As hundreds of Internet startups fail, the dot-com bubble bursts; the next year, Enron, the energy-trading juggernaut, is felled by delusional dealmaking and accounting fraud



2008

Lehman Brothers, also suffering huge subprime losses, heads toward liquidation, and a panicked Merrill Lynch sells itself to Bank of America; U.S. takes control of giant insurer AIG and mortgage financiers Fannie Mae and Freddie Mac

1989

Junk-bond market collapses, worsening the S&L debacle; Drexel eventually implodes, and Milken later pleads guilty to fraud

1999

A digital "New Economy" inspires an investor craze for technology companies with snazzy ideas but little or no profits



1998

Long-Term Capital's models misfire during Russian debt crisis, requiring a \$3.6 billion federally engineered bailout and leading to the firm's closure



1991

First Bush Administration wants to repeal the Glass-Steagall Act separating commercial from investment banking; the restriction is eliminated during the Clinton Administration

1994

With a pair of Nobel prizewinners on board, the hedge fund Long-Term Capital Management attracts attention for piling up huge gains while claiming to have discovered market models that drastically limit risk

CLOCKWISE FROM TOP RIGHT: CHASSON/LIAISON/GETTY IMAGES; EDMOND/SAP PHOTO; COPUS/EVENING STAR/DARDZUMA PRESS; EGGITT/AF/GETTY IMAGES; HONDROS/NEWSMAKER/GETTY IMAGES; LANZANO/AP PHOTO; AXEL KOESTER

forget the last tempest and reassure ourselves that things will be different from now on. Why don't we learn the obvious lesson to the contrary? Answers: the timeless power of hubris during periods when profits seem easy, and a set of foolish financial notions that have become prevalent over the past three decades.

One of those beliefs is the indiscriminate antiregulatory ideology one hears preached on Wall Street with tent-revival fervor. What makes this thinking so perplexing is that many of the free-market true believers also assume the federal government will save them if they flop. Consider the extraordinary taxpayer-backed rescues of insurance titan American International Group (AIG), housing financiers Fannie Mae and Freddie Mac, and, before those, the Treasury-guided merger of Bear Stearns into JPMorgan Chase. It brings to mind the homeowner who rants about getting Washington off his back but wants federally guaranteed flood insurance no matter how close to the Gulf Coast he builds his house.

Other by-now-familiar attitudes have helped put us in the drink: In good times, there's no such thing as too much leverage. (Remember Michael Milken?) Derivatives don't require oversight, even though almost no one understands them. (How now, Long-Term Capital Management?) And, don't worry, the quantitative geniuses have devised models to eliminate extreme risk. (Enron, anyone?)

"Now, again, the banks and the Bush Administration and [Treasury Secretary Henry] Paulson and [Federal Reserve Chairman Ben] Bernanke would like you to think these crises are like floods or hurricanes," says Michael Greenberger, a senior official at the Commodity Futures Trading Commission (CFTC) during the Clinton Administration. An advocate of more aggressive regulation of investment banks, he was shot down in the late 1990s by Democratic colleagues, not just GOP foes. Most financial calamities aren't like natural forces beyond control, Greenberger says. "These are predictable events." Predictable events, of course, are more likely to be prevented with sound rules and stiff enforcement.

DIFFERENT ANIMALS

Alfred E. Kahn offers the long view—a very long view. As the Carter Administration's aviation czar, he unshackled airline routes and fares in the late 1970s, reshaping that industry (for better and worse) and helping spur a lengthy era of economic deregulation. Still sharp at 91, the retired Cornell University economist and part-time consultant recalls that almost as soon as the free-market spirits were set loose, a furious stampede ensued. Lenders, for one, demanded lots more freedom. But they "were a different kind of animal" from airlines and trucking firms, which the Carterites also deregulated, Kahn says. "They were animals that had a direct effect on the macroeconomy. That is very different from the regulation of industries that provided goods and services.... I never supported any type of deregulation of banking."

During the Reagan years, Kahn's cautious industry-by-industry analysis was replaced by the all-encompassing anti-regulatory ideology of the University of Chicago. One

FORMER FED CHAIRMAN ALAN GREENSPAN ARGUES THAT THE PRICE OF ELIMINATING GIANT SPECULATIVE LOSSES IS A LOWER STANDARD OF LIVING

result: the liberation of an armada of savings and loan pirates, abetted by congressional Democrats as well as Republicans, many of them drunk on S&L campaign largesse. (Wall Street lobbyists with open wallets have since perfected the practice of neutralizing Congress on a bipartisan basis.) Hundreds of thrifts ultimately collapsed in the late 1980s and 1990s amid greedy and, in some cases, fraudulent real estate deals.

As early as 2000, William J. Brennan, a prominent consumer attorney who has represented mortgage borrowers since the S&L catastrophe, warned in testimony before the House Financial Services Committee that real estate finance would return in new guises to haunt us. Few listened. Behind every burst of ill-advised lending lurk financial innovators creating new mechanisms to entice ever-more-sketchy borrowers, says Brennan, the director of Atlanta Legal Aid Society's Home Defense Program. In the 1980s, Michael Milken and his comrades at the now-defunct Drexel Burnham Lambert investment bank exacerbated the S&L fiasco by hawking their thrift clients' high-risk junk bonds. More recently the likes of soon-to-be-defunct Lehman Brothers and Bear Stearns engineered the securitization of mortgages, encouraging home lenders to spew wildly unwise loans. "Lending without regard [for] the ability to pay back started with the S&L scandal," says Brennan. In the 1980s the borrowers were reckless shopping-mall developers; in the recent boom, unsophisticated and sometimes cavalier homeowners.

Wall Street transformed dicey subprime mortgages into the toxic securities that have required hundreds of billions in writedowns and that drove once-mighty Merrill Lynch to sell itself to Bank of America. One of the most striking aspects of the current turbulence is the degree to which banks invested in the noxious fare themselves, notes Emanuel Derman, who heads risk management at Prisma Capital Partners, a hedge fund in Jersey City, N.J. "These guys ate their own cooking; they didn't just pass it on to clients."

The outsize appetite on Wall Street for hazardous mortgage-backed securities and even more obscure derivatives has had a lot to do with the people in the kitchen failing to understand fully what was in their recipes. All of this is painfully familiar to anyone who paid attention to past adventures with wizards who claimed their esoteric models had magically eliminated risk and uncertainty. Hedge fund Long-Term Capital Management (LTCM) couldn't imagine Russia defaulting on its debt, much as Lehman apparently couldn't conceive of housing prices across the country deteriorating simultaneously, followed by a paralyzing credit crunch.

For four years in the mid-1990s, LTCM boasted extraordinary profits based on supposedly flawless computer formulas devised by a team that included two Nobel laureates. But in

HEDGE FUND TYCOON EDDIE LAMPERT ASSERTS THAT FANNIE AND FREDDIE'S RESCUE UNDERMINES CONFIDENCE IN OTHER BIG FINANCIAL INSTITUTIONS

the summer of 1998, Russian credit disintegrated, one of several concurrent global shocks that the LTCM crew had failed to factor into their algorithms. After losing more than \$4 billion in a few months—in retrospect, the amount seems almost quaint—the hedge fund received a federally organized rescue, although it later shut down altogether.

Financial “rocket scientists,” says Henry T. Hu, a corporate law professor at the University of Texas in Austin, have a knack for neglecting low-probability, catastrophic events. The smartest guys in the room at Enron similarly assumed away risks they didn't want to confront. “These models... work in normal circumstances but not during times of market stress, when it really matters,” Hu says. “It is almost like a safety belt that only fails in a serious car crash.”

One of the things that dismayed outsiders about LTCM after it came apart was the size and complexity of its derivatives portfolio. Some in the Clinton Administration pushed for more oversight of the unregulated, privately traded instruments whose value derives from price shifts in currencies, securities, or other assets. Then-Fed Chairman Alan Greenspan, allied with Robert E. Rubin, Clinton's Treasury Secretary (and now a director and senior counselor at Citigroup), opposed tougher policing of derivatives. Banks could watch over each other more effectively than regulators could, Greenspan argued. This turned out to be shortsighted.

In an interview, Greenspan doesn't back down, even after all we've seen lately. “The majority of lawyers, in my experience, seek to regulate—that is, to contain certain activities with little weight given to the lost benefits of such activities,” he says. “The question is: What do you lose? In this case, a very valuable instrument [credit default swaps, the derivatives at the core of the current mess] for the diminution of systemic risk. You can stop the system dead and eliminate speculative losses. But you will also get significantly reduced economic activity and ultimately lower standards of living.”

Greenspan adds: “I've been extraordinarily distressed by how badly the most sophisticated people in the business handled risk management. But the question is: If, protecting their own resources, they can't do it, who's going to do it better?” (Well, maybe regulators who don't have big bonuses at stake would be less likely to get carried away by the euphoria.)

Rubin says separately that he didn't oppose the general idea of scrutinizing derivatives, but instead argued against particular proposals in the late '90s to expand CFTC authority. “I have always been concerned about derivatives,” he says.

Greenberger, then the CFTC's director of trading and markets, recalls the Greenspan-Rubin resistance as being fierce and across-the-board. “If we had prevailed, the [subprime-securitization] party would never have gotten started; the wildness wouldn't have happened,” he says. “There would have been

auditing requirements, capital requirements, transparency. No more operating in the shadows. Bear Stearns, Lehman, Enron, and AIG would be thriving, and spending every waking hour complaining about regulatory restraints imposed upon them.” Now a law professor at the University of Maryland, Greenberger

adds: “In a booming economy, people couldn't be convinced that without corrections, LTCM would happen again—bigger and with more ramifications.” Today, Bear, Lehman, and AIG have untold amounts of outlandish derivatives on their books. It could be years before anyone untangles what they're worth.

One other legacy of LTCM is “moral hazard”: the prospect that other financial actors would take greater risks because at some level they'd assume that they, too, would be considered “too big to fail.” Surely one can surmise that Fannie Mae and Freddie Mac overstepped in part because of an implied federal safety net that turned out to be a very real one.

Edward S. Lampert, the hedge fund tycoon who controls Sears Holdings, worries about yet another twist. He says the current wave of federal intervention sends the opposite signal from what's intended: that officials are panicking because of broader instability. “As an investor, that was my immediate reaction” to the Fannie and Freddie moves, he says. “They completely destroyed confidence in any financial institution.”

Lampert frets that with investment banks failing and merging, the resulting consolidation will concentrate risk and invite more rescues. “You are going to have Citi, JPMorgan, and Bank of America with \$2 trillion-plus in assets each,” he notes. “That's three times the size of Fannie and Freddie. Now if they end up with problems, what do you think is going to happen? They are too big to fail.” | **BW** |

—With Robert Berner, Peter Coy, Keith Epstein, Brian Grow, and Chad Terhune

Business Exchange

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Too Big to Succeed?

The proposed merger of Merrill Lynch and Bank of America will create the largest bank in the U.S., with some \$2.7 trillion in assets. A Sept. 15 article on Slate's recently launched business-news Web site, *The Big Money*, argues that the firm's “Super Size Me diet will weigh it down,” especially given the troubled finances of Merrill and another recent acquisition, mortgage lender Countrywide. Why gobble it up, then? The author posits that BofA Chief Ken Lewis wanted an investment banking group of his own, especially after closing an in-house operation last year.

To read the piece, go to <http://bx.businessweek.com/financial-services-industry>



MORE

PAIN

AHEAD

By David Henry and
Matthew Goldstein
Illustration by Andy Martin

With the end of the credit crunch nowhere in sight,
Wall Street faces even more losses—and a humbler future
under the more watchful eye of regulators

WALL STREET IN CRISIS

Once-mighty Wall Street has turned into the Boulevard of Broken Dreams. From Bear Stearns and Lehman Brothers to Merrill Lynch and AIG, the punishment for years of bad decisions has been shockingly swift and brutal. As firms wobble, markets gyrate, and investors quiver, the question is: When will the pain end?

The signs aren't encouraging. Sure, the Federal Reserve's dramatic bailout of American International Group prevented the full-out global panic that might have unfolded with the collapse of the largest U.S. insurer (page 040). But AIG's sudden lurch toward bankruptcy also showed how dangerously intertwined the financial system has become.

For years that interconnectedness masked enormous underlying risks, but now it's amplifying them. As each new thread from the crazy web has unwound during the 13-month credit crisis, a fresh problem has emerged. How bad things will get from here depends on how cleanly the losing firms and toxic investments can be extricated from the rest. With each passing day the task seems to grow more difficult. By the

end of the credit bust, the total losses, now \$500 billion, could reach \$2 trillion, according to hedge fund Bridgewater Associates. What's likely to be left when the Great Unwind is finally complete? A smaller, humbler, highly regulated Wall Street barely recognizable from its heady past, where caution reigns and wild risk-taking is taboo.

PLENTY OF SKELETONS

Merrill's ties to AIG show just how difficult it might be to untangle the financial system. During the mortgage boom, Merrill churned out billions of dollars worth of dubious collateralized debt obligations, those troublesome bonds backed by pools of risky subprime mortgages. To cut down its own risk, Merrill bought insurance contracts from AIG called credit default swaps, which pay off if the mortgages blow up. Merrill holds \$5 billion worth of guarantees from AIG alone. In all, AIG insures \$441 billion of CDOs, including \$58 billion with the subprime taint. It's unclear which firms bought those guarantees, but AIG sold many to big European banks.

When AIG hit the skids, it couldn't be trusted to make good

on those contracts. If the insurer had remained in jeopardy, Merrill and others would have faced another round of losses. Given that possibility, it's no wonder the Fed stepped in.

The massive credit-default-swap market became so complex that in some cases firms lost track of their stakes. AIG, for example, pleaded for capital from several private equity firms over the Sept. 13-14 weekend. After scouring the insurer's financials, the firms balked at a deal, concluding that even AIG management didn't know where all the skeletons were buried, according to a person familiar with the situation. AIG disclosed in February that auditors had found "material weakness" in its systems for valuing its credit default swaps. In its quarterly report on Aug. 7, the company said it was still trying to implement a reliable valuation system.

The unwinding of Lehman, one of the world's biggest bond



players, won't be easy. When the firm filed for bankruptcy on Sept. 15, pain quickly rippled across the financial system. A day later, the \$62 billion Reserve Primary Fund, the world's first money-market fund, reported it had lost money on debt instruments issued by Lehman. Such losses are virtually unprecedented in money-market funds, which are supposed to be as safe as cash stuffed under a mattress. Wachovia, already reeling from mortgage losses, pumped extra dollars into three of its money-market funds after Lehman fell.

Lehman's tremors are being felt in other markets, too. One of the next danger zones could be the \$20 billion market for so-called catastrophe bonds, arcane securities sold by insurers to guard against big payouts on major natural disasters like hurricanes. Bond rating agency A.M. Best tells *BusinessWeek* it might trim the ratings on several catastrophe bonds backed by a Lehman subsidiary. Lehman also sold guarantees on commercial mortgage-backed securities, including some issued by the Italian government. In the wake



Lehman's New York HQ: Fallout from the firm's demise is widespread

of the firm's bankruptcy, those bonds might lose value.

As Lehman and Merrill faltered, investors began betting heavily against two other big independent investment houses, Goldman Sachs and Morgan Stanley. The fear: The banks' main funding sources would dry up. Goldman and Morgan Stanley are still alive, but their shares have been battered, falling by 14% and 24%, respectively, on Sept. 17 alone. In a recent conference call, Goldman said its goal was to remain a stand-alone firm. As of press time, Morgan Stanley was exploring a merger with Wachovia.

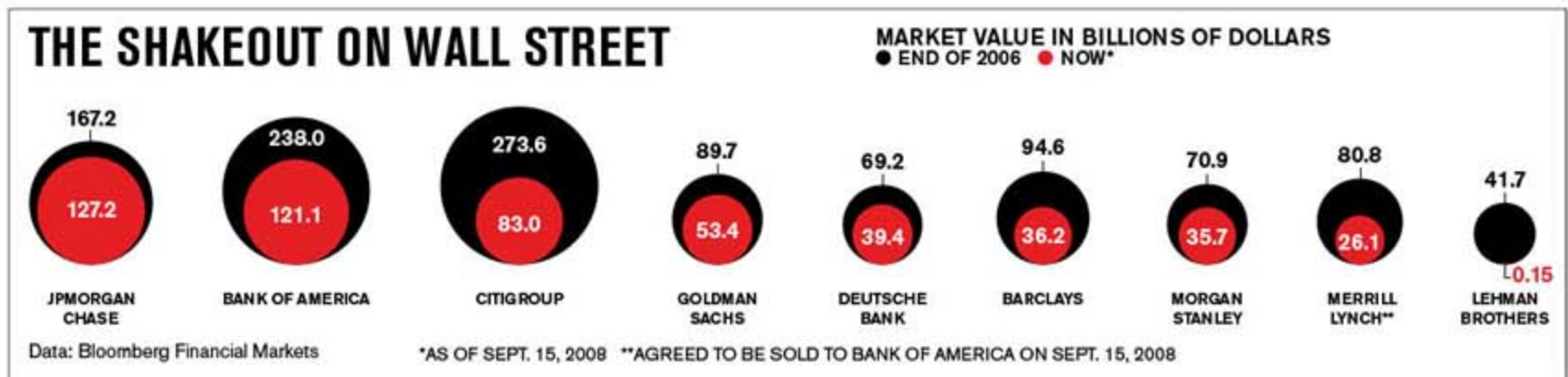
THE HOUSING SINKHOLE

A future without Goldman or Morgan Stanley is no longer inconceivable. Whereas big commercial banks like Citigroup and JPMorgan Chase rely on a steady base of deposits to finance their operations, large investment banks have come to resemble high-flying hedge funds, borrowing short-term cash from other firms to invest in riskier securities. Goldman's gross leverage ratio—one measure of borrowed money—jumped from 18.7 times assets in 2003 to 26.2 by 2007. Morgan Stanley's topped 32 last year. But the lenders in these esoteric markets hold all the power now. They can

demand at any time that borrowers put up more collateral or cut the financing altogether. That's what happened to Bear and Lehman—and investors worry a similar fate could befall Goldman and Morgan Stanley. "I don't think they could survive too many rounds of this," says Manhattan College finance professor and Wall Street historian Charles Geisst.

At the center of the global financial web, of course, sits the U.S. housing market—and here, too, the outlook seems bleak. Home prices continue to fall, reducing the values of mortgage-backed securities. More worrisome, the subprime contagion is spreading to categories of home loans once considered less risky. So-called Alt-A loans, made to people with better-than-subprime credit, are deteriorating rapidly. In normal times, 2% to 3% of such loans are troubled; now the figure stands at 15%. Delinquent subprime loans make up 30% of the subprime total, up from 10% historically. "Subprime in overall magnitude is bad," says Mark Fleming, chief economist for research firm First American CoreLogic. "But in terms of the magnitude of change, the Alt-A market is bigger."

Even homeowners with the highest credit ratings, known as prime borrowers, increasingly are falling behind on their payments. Prime mortgages make up 40% of all foreclosures.



PHOTOGRAPH BY JENNIFER S. ALTMAN; CHART BY DAVID FOSTER

Those sorts of problems will continue to rise through the mortgage food chain to lenders and investment banks.

Already there are new signs of distress. At the height of the mortgage boom, scores of small to midsize banks binged on risky debt investments called trust preferreds that allowed them to collect cash from investors and gave banks the right to defer their interest payments. With mortgage loans and related investments going bad, at least 38 banks in the past 12 months have stopped making their payments. Several have been seized by regulators, including IndyMac and Silver State Bancorp. For others, like FirstBank Financial Services, CapitalSouth Bancorp, and Omni Financial Services, the decision not to pay raises a red flag. First Bank, CapitalSouth, and Omni could not be reached for comment.

As the housing crisis continues to spread throughout the U.S. economy, new problems for financial firms make the Great Unwind all the more challenging. Defaults on corporate loans, for example, are likely to rise. According to Standard & Poor's Leveraged Commentary & Data, prices of corporate junk loans on Sept. 16 fell to a record low of 85¢ on the dollar as investors demanded higher yields for assuming the risk.

However the credit crunch plays out, one thing is certain: Wall Street, newly chastened, will never be the same. Its new catchphrase is "de-risking," or cutting back on lending, hoarding cash, and eschewing leverage. Marriages of commercial

POWER WILL MOVE BEYOND NEW YORK TO BANKS, HEDGE FUNDS, PRIVATE EQUITY SHOPS—EVEN SOVEREIGN WEALTH FUNDS—AROUND THE GLOBE

banks and investment banks could occur as former high-fliers come to crave the simplicity and stability of ordinary bank deposits. "The investment banks' model is a problem," says Nouriel Roubini, a New York University professor. "They will have to be regulated like commercial banks."

The geography will be different, too, as the balance of power shifts away from Wall Street's fabled corridors to other parts of the country and the world. Bank of America, now the largest bank by assets, calls Charlotte, N.C., home. Britain's Barclays, which agreed on Sept. 16 to buy parts of Lehman, could emerge among the elite as well.

And nontraditional firms will horn in on businesses once dominated by the Lehmans of the world. Private equity firms, hedge funds, and even sovereign wealth funds from the Midwest could expand further into traditional investment banking functions such as lending to early-stage businesses.

For years Wall Street has eaten everyone's lunch. The lesson of the Great Unwind is that the tables can be turned. **| BW |**
—With Tara Kalwarski, Mara der Hovanesian, Jessica Silver-Greenberg, Ben Levisohn, and Emily Thornton in New York

Business Exchange

WHAT THE WORLD'S NEWSPAPERS ARE SAYING

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Daily Telegraph (London)

There is a hubristic quality to [Lehman's] downfall—few firms so embodied the uglier aspects of Wall Street swagger. These seismic events will shake America's image of itself—aggressive capitalism is a brand it has exported to the world, and it has been found wanting.... [This] has happened on the Republicans' watch. They may pay a high price on Nov. 4.

The Guardian (London)

While talk of a 1930s-style depression is still conjecture, so are the predictions that failing banks and a bankrupt financial system will have minimal impact on the "real economy".... Take away the credit-fueled housing market and Britain is an economy with all its eggs in one basket. The stench from Canary Wharf is proof of what has long been suspected: Many of those eggs were rotten.

China Daily (Beijing)

A financial tsunami on the other side of the Pacific may hit [China].... Policymakers must come up with preventive measures that can cushion the national economy against a much dimmer global growth outlook. There is already talk that deflation is starting to play upon investors' minds again as a result of falling house prices, failing financial institutions, and weaker growth in major developed economies.



Le Figaro (Paris)

There's a great temptation to add to the existing hodgepodge of regulations. But the current crisis shows the limited effectiveness of a multiplication of purported safeguards. It would be healthier to instead overhaul current banking practices, for instance by reining in unreasonable bonuses and incentives that encourage speculation.

Süddeutsche Zeitung (Munich)

The rise and fall of the big investment banks shows where greed can lead—the way up, but also the way down. America's climb to become the biggest economic power of the world would not have been possible without the Wall Street money machine. [Now] America...stands before a recession the likes of which it has not experienced for a long time. And the whole world suffers.

Nikkei (Tokyo):

[In 1997] Japan was criticized by the U.S. and other nations for possibly sparking a global financial panic. Ultimately, it would take another five or six years to resolve the Japanese banks' bad loans. A prolonged U.S. financial crisis would have a far bigger impact on the global economy than Japan's banking turmoil had. U.S. financial authorities should do everything they can to prevent that from happening.



For more global commentary, go to <http://bx.businessweek.com/credit-crunch>

THE FED'S

MONEY

MACHINE

By Peter Coy

Illustration by Sean McCabe

There are limits to the central bank's power, but it still has lots of ammo left

WALL STREET IN CRISIS

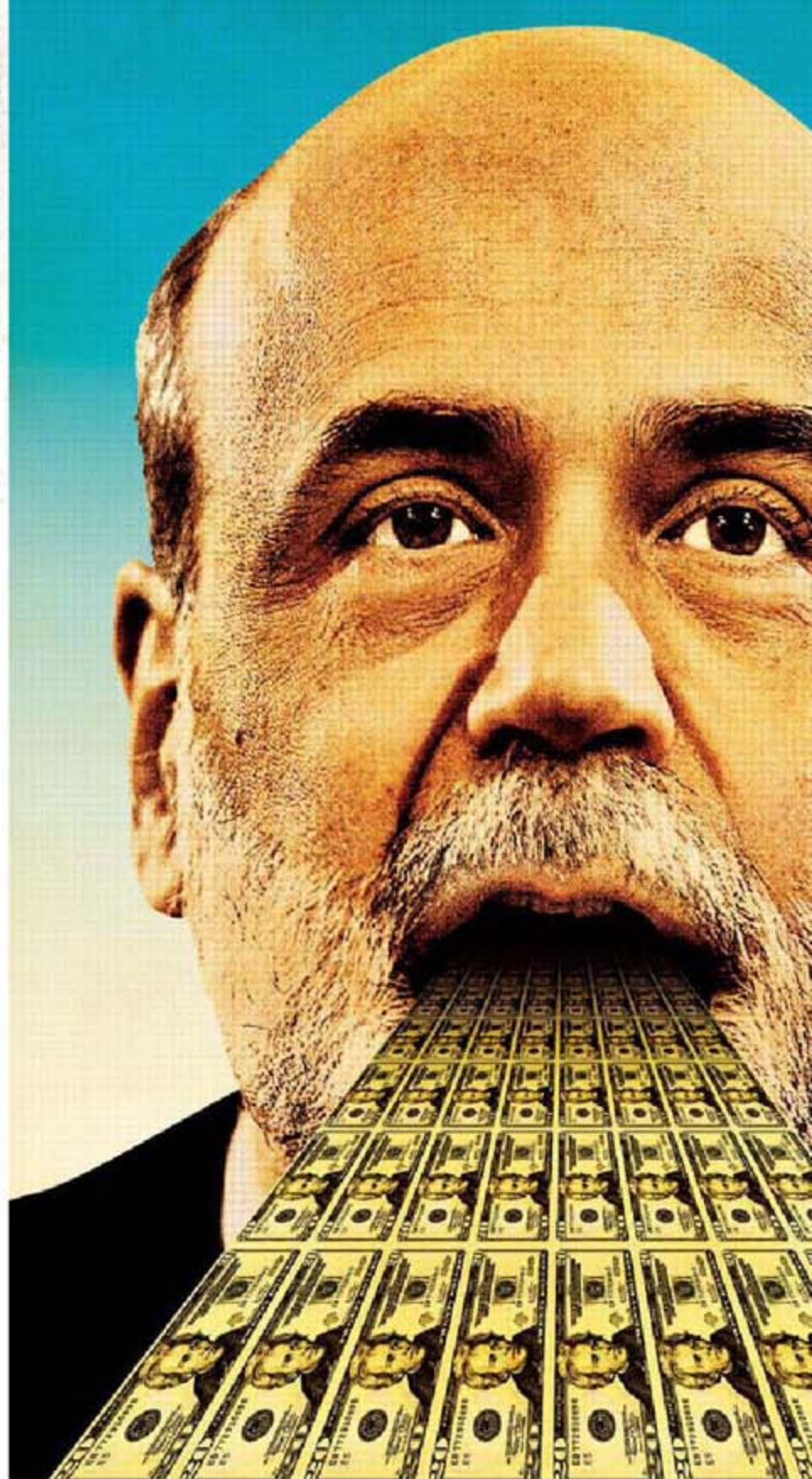
Never underestimate the power of a central bank, which can conjure up money from thin air. Federal Reserve Chairman Ben Bernanke and his fellow central bankers around the world cannot stop asset prices from falling, nor do they want to. They realize markets need to find a firm bottom before they can begin to recover.

What the central bankers can do, and are determined to do, is keep the banking system operating effectively even as trillions of dollars in wealth evaporate and panic weakens or kills stalwarts of the financial Establishment such as Fannie Mae, Freddie Mac, Merrill Lynch, Lehman Brothers, and American International Group.

Some people are worried that a crisis of this magnitude is too big for the Federal Reserve System, which has a relatively paltry \$900 billion in assets on its balance sheet. But the tools to deal with crises like this exist, and they've been proven to work. Says Charles Goodhart, a monetary policy expert at the London School of Economics & Political Science: "An intelligent central bank, well managed at the top, ought to be able to stop" the kind of downward spiral that gave Japan its deflationary lost decade of the 1990s.

POWER AND CONSTRAINT

There's no question that credit markets are more dysfunctional than they have been in generations. Banks are afraid to lend to one another, and investors are fleeing to the safest of assets, driving the yield on the three-month Treasury bill on Sept. 17 to less than one-tenth of 1%. Investors are fleeing from any institution that depends on short-term borrowing to finance long-term, illiquid investments—including investment banks Goldman Sachs and Morgan Stanley, whose shares



came under heavy selling pressure on Sept. 17. The danger is that even healthy, solvent institutions will be dragged under because lenders will refuse to supply them with the funds they need to stay in business.

The good news is that Congress founded the Federal Reserve in 1913 to deal with precisely this type of crisis. The Fed and other central banks are unique in their exclusive power to create money. In the current emergency, the Fed is manufacturing (virtually) tens of billions of extra dollars to slake the thirst of cash-hoarding banks and make emergency loans. The Fed didn't need to scrounge around in a cash drawer for the up to \$85 billion that it's lending to insurance giant American International Group. It is simply noting in its books that henceforth, AIG can draw on an \$85 billion line of credit that it didn't have before.

And the Fed has plenty of ammunition left. For one thing, it could cut interest rates again. On Sept. 16 it chose to leave



the federal funds rate at 2%, judging that lowering the rate now might spark higher inflation. But if the credit crunch continues to sap the vitality of the economy, inflation will cease to be an issue and the Fed will have free rein to drive the federal funds rate down almost to zero, if need be, by purchasing Treasury securities from banks. That would give those banks more money that they could then lend to businesses and consumers.

If a near-zero interest rate still doesn't do the trick, the Fed could flood the financial system with even more money by buying up other assets—not just Treasuries but riskier kinds of bonds and even, in an emergency, stocks.

There are limits to the Fed's power. Obviously, flooding the financial system with money risks inflation in the long run. That's why the Fed needs to drain extra reserves as soon as the economy stabilizes. There's a political constraint as well. The Fed risks losing its cherished independence if it gets too deeply involved in the sensitive issue of picking winners and losers.

In addition, fighting the credit crunch too aggressively would keep asset prices artificially high and prop up weak financial institutions that deserve to die, says Mark Gertler, a New York University economist. That would delay the recovery by leaving investors afraid to buy (because prices remain too high) and banks unable to lend (because they're still saddled with bad loans).

Another problem: Historically, the Fed's main tool for helping troubled institutions is to lend them money. But excessive borrowing is what got us into

this mess. Meanwhile, U.S. investors aren't interested in buying new issues of bank stocks, and sovereign wealth funds that bought into the sector earlier this year have little appetite for throwing good money after bad (page 46).

That's where other branches of government may need to supplement the Fed's efforts. One idea is to create an agency to buy up bad assets, replenishing the banks' capital bases (please see following story). If that's not enough, the next step would be what the Scandinavian nations did in response to a banking crisis in the early 1990s. They nationalized their big banks, later selling them back to investors for a profit. That's not a step to be taken lightly, nor is it a job for the Fed alone. Says Goodhart, the British economist: "If you're going to be supplying capital, it's got to be the Treasury that does it."

For now, though, it's comforting to know that whatever else happens, the Federal Reserve isn't going to run out of money. |BW|

(RIGHT) BETTMANN/CORBIS

TIME FOR A NEW RTC?

By Jane Sasseen

Calls are rising for a buyer of last resort like the one that eased the S&L crisis

In the late 1980s, Washington created the Resolution Trust Corp. to restructure the mortgages held by 750 insolvent savings and loans. By selling off assets over time rather than in a fire sale, the RTC lessened the cost of the crisis to taxpayers.

So far, the feds' ad hoc solutions have failed to stem the crisis, leading many people to call for a new RTC. Ex-Treasury Secretary Lawrence H. Summers and former Federal Reserve Chairmen Alan Greenspan and Paul Volcker are backers, as is Representative Barney Frank (D-Mass.), the powerful head of the House Financial Services Committee. Treasury Secretary Henry Paulson has rejected the idea. But if things get worse, "the odds rise in the next Administration," says Tom Gallagher, head of policy research at broker ISI Group.

A new RTC would be a buyer of last resort. It might buy the mortgages and related debt from banks at a heavy discount or in exchange for equity. Or it could let troubled institutions go bust, then liquidate those assets in an orderly fashion. "Rather than seeing forced sales for 10¢ on the dollar, the government could take its time and get, say, 40¢ on the dollar," says Lawrence J. White, an economics professor at New York University.

There are problems, though. The RTC took on some \$225 billion in junky S&L assets and sold them for \$140 billion, but today's price tag could be far higher. And restructuring the complex mortgage-backed securities that are at the heart of the 2008 crisis would be much tougher than working out simple home loans. Finally, "doing this would be an admission that we are in deep, deep trouble," says Brad W. Setser, a former Treasury official who is now at the Council on Foreign Relations. But, he adds, "if the situation doesn't stabilize, we have relatively few policy options left." |BW|

—With Theo Francis in Washington



S&L depositors in 1985: Today's mess is bigger

WHERE AIG WENT WRONG

By Nanette Byrnes

**An underwriter's job is to spread risk.
But AIG let itself become seriously
overexposed to one shaky sector**

WALL STREET IN CRISIS

Amid all the debate about the long-term impact of an \$85 billion federal loan to American International Group, one thing is clear: The world's most sophisticated insurer proved to be far from adept at managing its own risk. Despite \$110 billion in annual sales and assets in excess of \$1 trillion, AIG stood at the brink of bankruptcy on Sept. 16. As management persuaded New York regulators to waive insurance rules so it could essentially tap subsidiaries for cash and tried in vain to raise \$75 billion from Wall Street, AIG's shares fell as low as 1.25 (down from a 52-week high of 70). The taxpayer-funded bailout, which gives Washington warrants for an 80% stake in the company, won't bring back the \$184 billion, or 97% of shareholder capital, that has evaporated in less than a year.

How did this happen? One place to start is former Chief Executive Maurice R. "Hank" Greenberg, who built AIG into a global behemoth during his four-decade tenure, in part by expanding into complex lines of business and insuring risk that few would dare to touch. Although forced to step down in 2005 amid an accounting scandal, Greenberg remains AIG's largest individual shareholder and a harsh critic of how AIG was managed under

AIG'S TAILSPIN

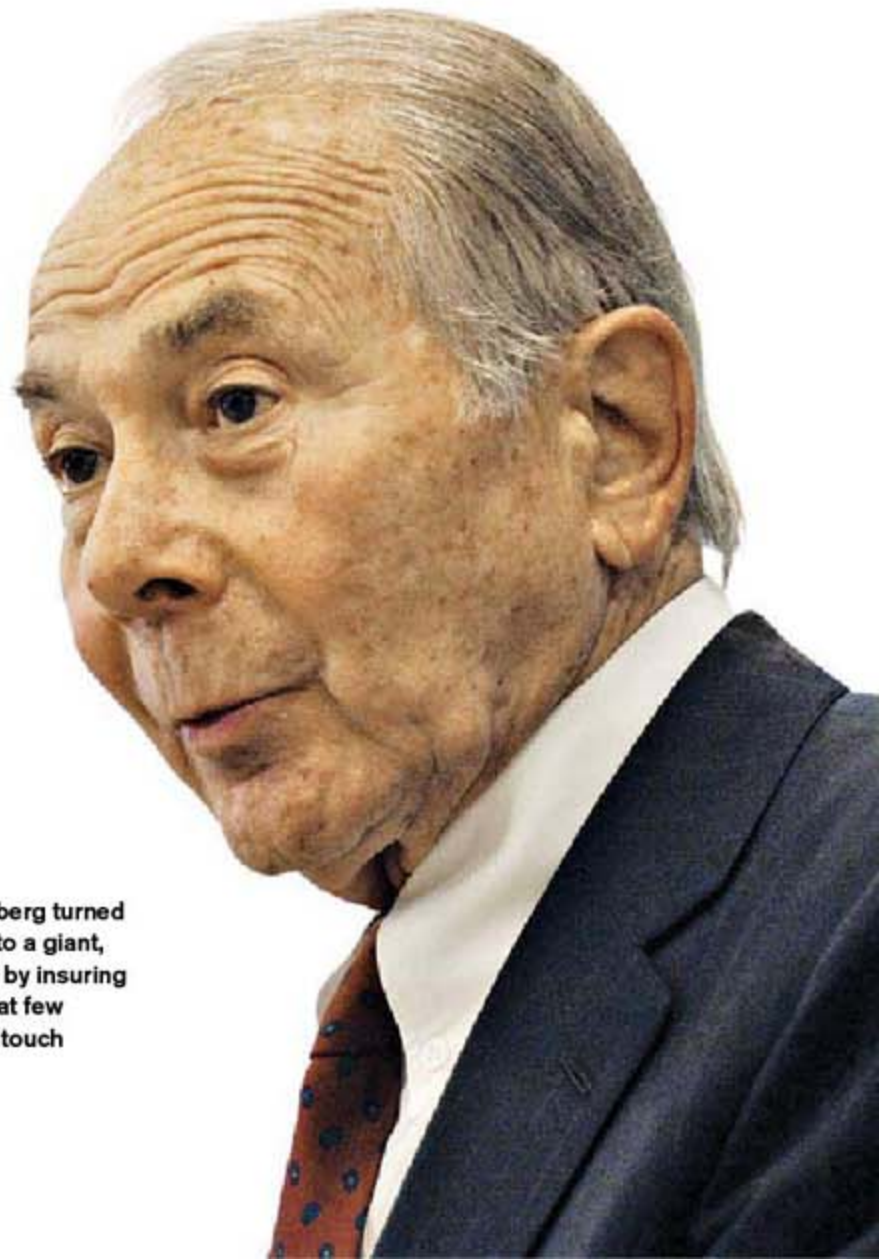


Martin Sullivan and Robert Willumstad, who stepped into the CEO role in June. Under the federal deal, former Allstate chief Edward M. Liddy will replace Willumstad. AIG's board of directors issued a statement saying the federal loan will protect policyholders, address rating agency worries, and "give AIG the time necessary to conduct asset sales on an orderly basis."

Greenberg told *BusinessWeek* on Sept. 17 that the government went too far: wiping out average shareholders with a bailout when all that was needed was a short-term loan to cover AIG's obligations. And he insists things would have been different had he remained at the helm. "I would not have waited until it got to this point," says Greenberg. "We had very strict risk-management controls. Those were obviously not followed." Hours before the rescue package was announced, he led a group of investors who alerted the Securities & Exchange Commission that they were looking at buying AIG assets or even assuming control. But AIG says its financial woes stem from actions taken in 2005 and earlier, when Greenberg was still in charge. "He took a lot of risk," says David Shiff, editor of *Shiff's Insurance Observer* and a longtime AIG critic.

BANKING ON ITS GOOD NAME

AIG got into derivatives in 1987. A decade later credit derivative swaps—contracts that transfer and, ideally, insure against credit risk—took off. AIG's superb credit rating helped it become a leading player. It often sold protection on other contracts, using its own sterling rating to essentially insure others' collateralized debt obligations (securities often backed by a pool of loans) against losses. Those promises would later haunt AIG. As Jamie Cawley, CEO of IDX Capital, explains: "They



Greenberg turned AIG into a giant, in part by insuring risk that few would touch

were able to monetize their credit rating [and] rent it.”

AIG was exposed to the U.S. housing market on other fronts, too. It had a mortgage insurance business, United Guaranty, that started to rack up big losses in 2007. It also had invested in mortgage-backed securities that led to \$12 billion in costs over the past year as their values plunged—money it owed to its insurance companies in order to maintain strictly regulated capital requirements. By early 2008 it was clear that the company’s derivatives were eroding at a rapid clip. AIG’s audit firm, PricewaterhouseCoopers, forced it to change how it was valuing the products. That caught the attention of Donn Vickrey, an analyst at Gradient Analytics, who began to question AIG’s earnings quality. He went back into the company’s SEC filings and chronicled the sharp declines in the valuation of its derivatives. The cumulative losses swelled from only \$352 million as of Sept. 30, 2007, to \$6 billion just two months later. (How big that figure is now, Vickrey says, is “unknown.”) AIG, which had already paid record fines to regulators following its accounting woes, restated earnings, and ousted its chief to assuage regulators, was again under the microscope.

Over the spring, the stock fell. In June, former AIG director Eli Broad and two prominent investors—Shelby Davis of Davis

FOR ALL ITS PROBLEMS, FEW DOUBTED AIG’S ABILITY TO MEET OBLIGATIONS— UNTIL ITS CREDIT RATING FINALLY CAVED IN

to repay its obligations. It was still one of the world’s most recognized corporate brands, with operations in 130 countries. Its enviable credit rating allowed subsidiaries such as International Lease Finance Corp., its aircraft leasing arm, to borrow on preferable terms. Without that advantage, the logic of staying within AIG would diminish. When AIG reported a \$5.36 billion loss in August, talk of a spinoff grew louder.

CANDIDATE FOR EXTINCTION

Then the bodies began to pile up on Wall Street, with Lehman going into bankruptcy and Merrill selling itself to Bank of America. If AIG needed yet more cash, where was it going to find it? Washington said financial players were now on their own.

Ratings agencies began to downgrade AIG on Sept. 15, triggering terms in their derivatives contracts that required them to come up with an additional \$14.5 billion in capital. Having already raised \$20 billion in capital through stock and debt offers

in May, and \$4 billion in a private investment just weeks ago, options were limited. With its stock trading below the cost of Manhattan subway fare, AIG looked like the next candidate for extinction.

On Sept. 16, the Fed begrudgingly admitted it couldn’t let that happen. AIG, with a swap portfolio valued at \$441 billion, involving most of the world’s major financial players, was too big to fail. But Washington, which is-

issued a 2-year adjustable-rate loan starting out at roughly 11%, doesn’t want long-term ties to AIG. Without knowing all the deal’s terms, stockholders, fearing a dilution of their stakes, lopped \$4.6 billion more from its market cap on Sept. 17.

The primary job of an underwriter is to spread risk around. In making bold bets on home prices, AIG left its business exposed to one terrible turn of events and is paying a steep price. For taxpayers, the question is how deep the mess can get—and how long it will take AIG to get out of it. Then there’s the issue of whether \$85 billion is enough to do the trick. The government has taken a bigger stake than is typical in bridge loans, experts say, exposing it to the risks of a company whose capital needs have been escalating. “I don’t think anyone really knows the risks” says Vickrey. “If they say they do, they’re fibbing.” | **BW** |



Hong Kong: AIG's global business ties prompted the bailout

Selected Advisers and Bill Miller of Legg Mason—sent a letter asking the board to name an interim CEO to replace Martin Sullivan. Among other things, the mounting subprime losses had caused AIG to report a record \$13 billion in losses over the previous two quarters. Greenberg sent a similar missive and criticized his onetime protégé. Management had completely lost credibility, Greenberg argued, and the business was “in crisis.” Coming from Greenberg, it was a damning assessment. (Phone calls to Sullivan’s home in Chappaqua, N.Y., were redirected to AIG’s public affairs office.) AIG Chairman Willumstad, a former Citigroup executive, was named CEO.

AIG’s credit rating remained critical to its survival over the summer. Even as earnings declined, the company’s ratings remained strong. For all its problems, few doubted AIG’s ability

AFTERSHOCKS

BEYOND

THE STREET



By Michael Orey
Illustration by Andy Potts

Repercussions around the world range from tighter credit and curtailed spending to halted bond issues

WALL STREET IN CRISIS


The American Conservatory Theater in San Francisco would seem to have little connection to Wall Street. But not when you hear Executive Director Heather Kitchen chronicle the impact of tumultuous financial markets on the theater this year: declining ticket sales, a falloff in gifts from small donors, and earlier in September, layoffs of valued staff. Then, Kitchen says, on Sept. 15, she and ACT's administrative director watched in horror as the Dow plunged 500 points. ACT's roughly \$20 million endowment is now performing so poorly that there is little income to tap for operating funds. Says Kitchen: "I'm really shaken to see what's going on."

From big corporations and arts organizations to restaurants and retailers, the shocks emanating from Wall Street are rattling confidence, upending assumptions, and recasting business plans across the nation and around the globe. The financial markets, of course, are just one part of the picture. Oil prices, home values, and worldwide economic trends all factor into the mix. But Lehman Brothers' collapse and the subsequent stock market swoon on Monday had immediate

impact in some quarters. Government-owned Korea Development Bank, for one, promptly shelved a plan to issue up to \$1 billion in global bonds. Some of the misadventures were almost comic: On Monday morning, as part of a huge promotional event that Starwood Hotels & Resorts Worldwide staged in Manhattan's Central Park, Chief Executive Frits Van Paasschen remotely rang the opening bell of the New York Stock Exchange. "If I had known what sort of a news day it would [be]," Van Paasschen says, "it wouldn't have been the day I would have picked."

"I'D HAVE NEVER THOUGHT IT WOULD HAPPEN"

By Wednesday the public had additional stunning news to digest: The government bailout of American International Group and a 38% midday swoon in Morgan Stanley's share price. The crumbling of financial industry mainstays hit close to home for some. Since the mid-1990s, NorthMarq Capital, a commercial real estate banker in Minneapolis, counted Lehman as one of its largest purchasers of loans for securitization. Even as NorthMarq CEO Edward Padilla felt the full



mic in North America, will now turn down in Europe and Asia. "It's not directly correlated to Lehman and Merrill Lynch," says Alapont. But "one way or another, the financial turmoil has an impact."

SELLING FEWER FISH

Roger Berkowitz, CEO of Legal Sea Foods, a restaurant chain based in Boston, says his corporate catering business is off nearly 10% over the past two months, and Legal has curtailed expansion outside New England. Berkowitz, also a director at Century Bancorp, a regional bank in Medford, Mass., says he's glad the feds seized control of AIG. "I thought it was a Solomon-like decision," he says. "They picked and chose, and I think they picked wisely [in bailing out AIG and not Lehman]. If AIG went, it would screw everyone." Paul Weinschenk, a vice-president at Peterson Cos., a property developer in the Washington area, agrees that the government has to "ensure some stability [in] the financial market." His company has spent a decade developing a 500-acre residential and commercial center in Gainesville, Va. The retail portion was due to open early next year. But now, Weinschenk says, tighter credit and big stores' reluctance to lease make fall 2010 the "best-case scenario."

Not everyone is buying into the general expressions of gloom. Daniel J. Warmenhoven, CEO of data storage company NetApp (formerly Network Appliance), counts himself lucky that neither Lehman nor AIG was a big customer (though Lehman did take the company public). He says tech spending is holding up so far—in part because it lowers operating

costs. "The analysts are always 'woe is me,' because their industry is getting hammered," says Warmenhoven. "Well, go cry in your own beer. Don't ruin mine." Stephen I. Chazen, president and chief financial officer of Occidental Petroleum, echoes that. The havoc on Wall Street "certainly makes you more conservative," he says. But as the current crisis unfolds, he notes, "I watch these commentators on TV and say, 'Why would anybody listen to this?...' Why are we turning for advice to people who work for completely failed institutions?" **| BW |**

—With Matthew Boyle, Lawrence Delevingne, and Aili McConnon in New York, Chris Palmeri in Los Angeles, David Kiley in Detroit, and bureau reports

brunt of the mortgage turmoil in his own business, he says he always believed "that Lehman would be one of the handful of survivors." Now he'll have to find another partner when the securitization business comes back. And Frederick A. "Fritz" Henderson, president and chief operating officer of General Motors, says, "If you would have told me coming into this year that of the five major investment banks, three would be sold or in bankruptcy, I'd have never thought it would happen." Now, he says, "financial institutions will be even more cautious," making it harder for car buyers to get loans.

For most, the fallout from Wall Street has less to do with the fate of a particular institution or even several bad days for stocks. Instead, a yearlong period of tumult, uncertainty, and anxiety about when and how it might end has led consumers and companies alike to rein in plans to spend or expand. José Maria Alapont, CEO of auto parts supplier Federal Mogul in Southfield, Mich., predicts that auto sales, already ane-

**WHEN AND HOW THE TUMULT, UNCERTAINTY,
AND ANXIETY MIGHT END HAS LED CONSUMERS
AND COMPANIES ALIKE TO CUT BACK**