

CRISIS WATCH ▶ **THE CREDIT CARD TIME BOMB**

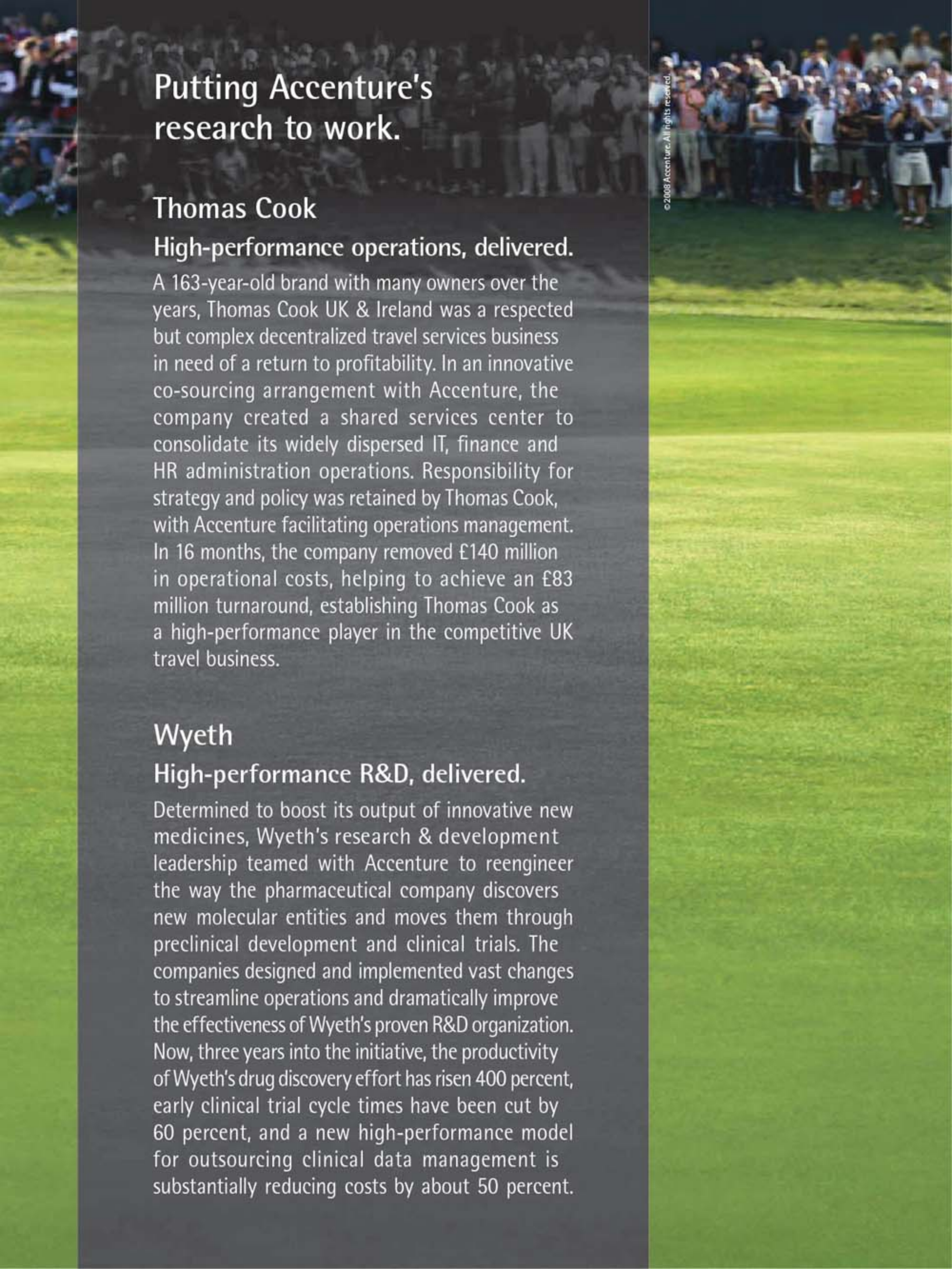
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OCTOBER 20, 2008 | BUSINESSWEEK.COM

BusinessWeek

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**MORTGAGE
MELTDOWN:
THE WATCHDOGS
WHO WARNED US**



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THE BOLD LOOK
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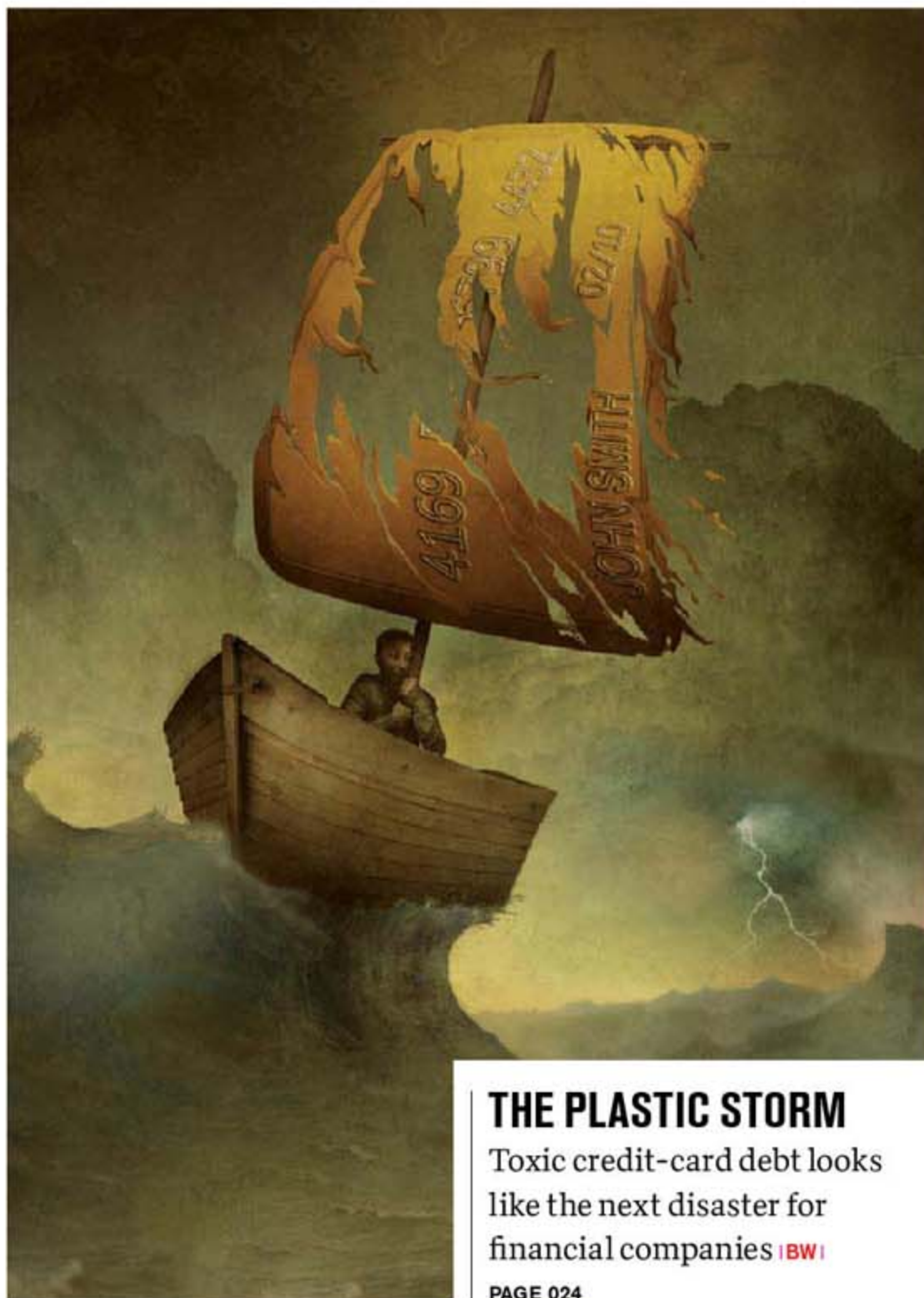
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THE PLASTIC STORM

Toxic credit-card debt looks like the next disaster for financial companies | **BW** |

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FINANCIAL TURMOIL SPREADS WORLDWIDE

The U.S. House of Representatives' passage of the \$700 billion rescue package already seems so—well, last week. After a brief moment of relief, investors focused on their fears again, and the result was a drawn-out bloodbath on global bourses. The Dow sank 370 points on Monday, 508 on Tuesday, and 189 more on Wednesday. The toll in Europe on Monday alone: Britain down 7.9%, Germany 7.1%, France 9%. Emerging markets joined in, with Russia off 19% on Monday and Brazil dropping 13% in the three days through Oct. 8. Asia got into the act in a big way on Wednesday as Hong Kong, Singapore, South Korea, and others fell 5% or more and Japan cratered by 9.4%, the biggest one-day loss there in two decades. "This isn't normal," said new Japanese Prime Minister Taro Aso, in the understatement of the year. The plunge, he added, is "frankly beyond our imagination."

As it became clear that the U.S. bailout hadn't calmed the markets, authorities tried to craft a more global response. Governments made vast amounts of money available to banks in hopes of unfreezing credit. The Fed entered uncharted waters by announcing that it will start buying short-term debt from nonfinancial corporations. And on Oct. 8 six major central banks, including the Fed, slashed their benchmark

interest rates by half a percentage point in a bid to limit the economic damage wreaked by the crisis.

The contagion seemed to be spreading most virulently to Europe. Britain unveiled plans on Oct. 8 to inject up to \$88 billion into major banks in return for equity stakes and up to \$800 billion to ease liquidity. European financial ministers on Oct. 7 proposed increasing deposit guarantees for bank customers to head off runs. Iceland apparently teetered on the edge of bankruptcy, nationalizing two of the nation's three biggest banks and pleading for a \$5.4 billion loan from Russia. Among other banks falling into state hands was the Dutch

subsidiary of Benelux lender Fortis. The German government announced on Oct. 5 a new \$68.3 billion plan to prop up Hypo Real Estate after commercial lenders pulled out of a previous deal.

BW | PAGE 028 "How to Stop the Panic"
PAGE 032 "Stocks: Fishing for the Bottom"

HEDGE FUND BLUES

Among the investors getting clobbered in the chaos are the alleged best and brightest—that is, hedge funds. Chicago-based Hedge Fund Research says the average fund has lost 9.41% this year. Of course, that's a lot better than the more than 30% plunge in the S&P 500, but hedge managers are supposed to be





Traders in São Paulo on Oct. 8, as stocks took a dizzying plunge

expert at managing risk and navigating both soaring and tumbling markets. Instead, **Ken Griffin's Citadel Investment** has seen its main fund post a nearly 20% decline this year, industry sources say. Other prominent losers include big funds managed by **QVT, Third Point, Tosca, and Kinetics**. But it's not all devastation. One notable winner is **John Paulson**, whose \$30 billion **Paulson & Co.** boasts several big funds with double-digit gains this year.

REALITY BITES BofA

Maybe they should have thrown in a free toaster. **Bank of America** on Oct. 6 reported a 68% drop in third-quarter earnings, below Wall Street's expectations. It also slashed its dividend by 50%. That so unnerved investors that they balked at BofA's original price on a share offering to shore up its capital base, and it had to cut the price from \$28 a share to \$22 in order to raise \$10 billion.

WHO GETS WACHOVIA?

Ben Bernanke may need to summon his inner Solomon to settle this feud. When Wachovia's board on Oct. 3 said it would renounce its earlier, government-brokered deal to be acquired by **Citigroup** and would accept a higher, \$15 billion offer from **Wells Fargo**, Citi didn't take the rejection well. Citi sued Wachovia, Wachovia sued back, and the prospect of a protracted legal battle prompted Fed officials to call a ceasefire in hopes that they could forge a compromise, with Citi and Wells

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008 NEWS YOU NEED TO KNOW



each getting a slice. On Oct. 8, *The Wall Street Journal* said Citi will recruit partners to join in its quest for the bank, suggesting the dispute could drag on.

➤ "Wachovia: A Split May Boost the Banking Industry"
businessweek.com/magazine

MCCAIN'S SURPRISE

With Senator Barack Obama edging ahead in the polls, most pundits figured Senator John McCain needed to pull off something dramatic in the Oct. 7 Presidential debate. That didn't happen. But McCain did come up with one policy surprise: He wants to spend \$300 billion to buy loans of homeowners nearing foreclosure and help them arrange more affordable mortgages. As his campaign

explained later, the change from what Congress enacted in a bill this summer—and what Treasury is expected to do as part of its rescue plan—is that lenders and investors would receive full value of original mortgages, though homes often are worth far less. Taxpayers, rather than lenders, would eat the difference.

➤ "McCain's Mortgage Bailout Plan"
businessweek.com/magazine

BAD OMEN ON PROFITS

The biggest aluminum maker in the U.S. looks as mighty as a crumpled old can. Alcoa kicked off the third-quarter earnings parade on Oct. 7 by reporting a 52% plunge in profits, to \$268 million, as revenue slipped 2%, to \$7.23 billion. The company said it had suspended all "noncritical" capital outlays and share buybacks. Alcoa stock promptly hit a 10-year low, closing on Oct. 8 at 14.91. That's down 67% from its May peak of 44.77.

GOOGLE-YAHOO IN LIMBO

The search advertising deal that set rivals and watchdogs snarling has been put on hold as of Oct. 3 to give the Justice Dept. more time to review it.

The pact calls for Yahoo! to run some of Google's ads on its pages to boost Yahoo revenues by as much as \$800 million a year. But many advertisers—and rivals such as Microsoft—worry about the deal's potential to make the 800-pound Google even more powerful. Some observers think Justice could give its O.K. by the end of October, imposing restrictions or oversight.

At Google headquarters: Its advertising deal with Yahoo! is on hold for now

BATTLE IN THE AISLES

The balance of power between consumer product companies and retailers is shifting. The big chains have spent several years raiding the ranks of Procter & Gamble, Unilever, and Nestlé for marketing talent to build their own private-label brands. Now they want consumer product companies to spend more on in-store marketing. And why not? A recent survey by Deloitte Consulting and the Grocery Manufacturers' Assn. showed that in-store promotions yield a higher return on investment compared with ads in traditional media.

➤ *Advertising Age*

SCORE ONE FOR ICAHN

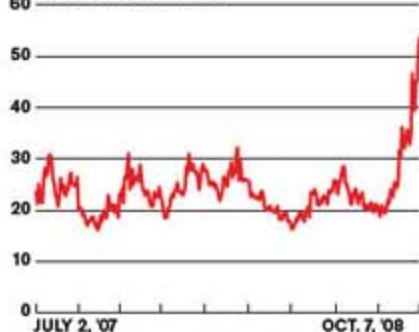
We won't have ImClone to kick around much longer. As



By buying Imclone, Eli Lilly lands Erbitux and a promising drug pipeline

HIGH ANXIETY

VIX VOLATILITY INDEX*



*The Chicago Board Options Exchange VIX index measures market expectations of stock volatility, using data on puts and call options
Data: Bloomberg Financial Markets

(FROM TOP) MARK LENN/AN/AP PHOTO; JB REED/BLOOMBERG NEWS; CHART BY RAY VELLA/BW

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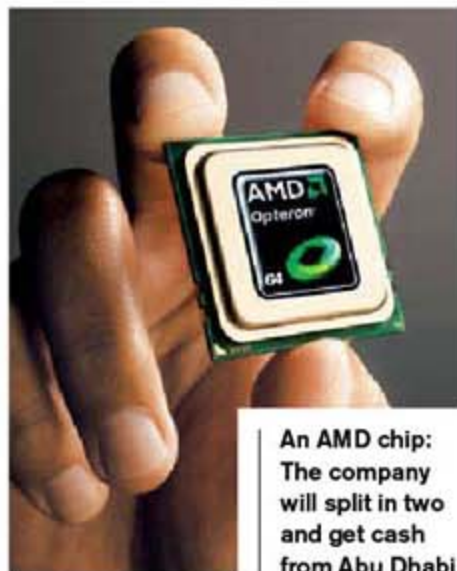
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rumored last week, **Eli Lilly** proved to be the mystery suitor cited by Imclone **Chairman Carl Icahn** in spurning **Bristol-Myers Squibb's** \$62-a-share bid. Lilly agreed on Oct. 6 to buy the biotech for \$65 million, or \$70 a share, a 50% bump over the price in July before Bristol's offer. ImClone's only product on the market is cancer drug **Erbix**, but Lilly mostly wants the pipeline. Imclone will forever be linked to the insider-trading scandal that sent founder **Sam Waksal** and his pal **Martha Stewart** to jail.

BW | PAGE 072 "Lilly's Risky Rush into Cancer Drugs"



An AMD chip: The company will split in two and get cash from Abu Dhabi

TATA'S STRATEGIC RETREAT

Tiny car, monster hassle. India's **Tata Motors**, which is all set to launch the \$2,500 **Nano** by yearend, said on Oct. 6 that it's ditching the already-built factory at Singur, near Kolkata, and trucking on over to Sanand in the west Indian state of Gujarat. Months of protests by peasants and local politicians against land acquisition methods at the original site had stalled work. Until the Sanand plant, with a capacity of 250,000 vehicles annually, is ready, Tata may consider using existing facilities in Pune, near Mumbai, and Pantnagar in north India to meet the deadline.

A HELPING HAND FOR AMD

Groaning under the weight of building and maintaining multibillion-dollar factories, **Advanced Micro Devices** said on Oct. 7 that it will split into two companies—one devoted to designing and selling microprocessors and graphics chips for PCs, the other to manufacturing them. AMD will be a minority partner in the new outfit—for

now called Foundry Co.—with an **Abu Dhabi** investment firm holding the rest. But it's getting \$1.2 billion in debt off its books, plus \$700 million in badly needed cash and equity amounting to 44%. AMD stock rallied about 8% on the news.

▶ "AMD's Spin-off: Abu Dhabi to the Rescue"
businessweek.com/magazine

GOING, GOING....FIRED!

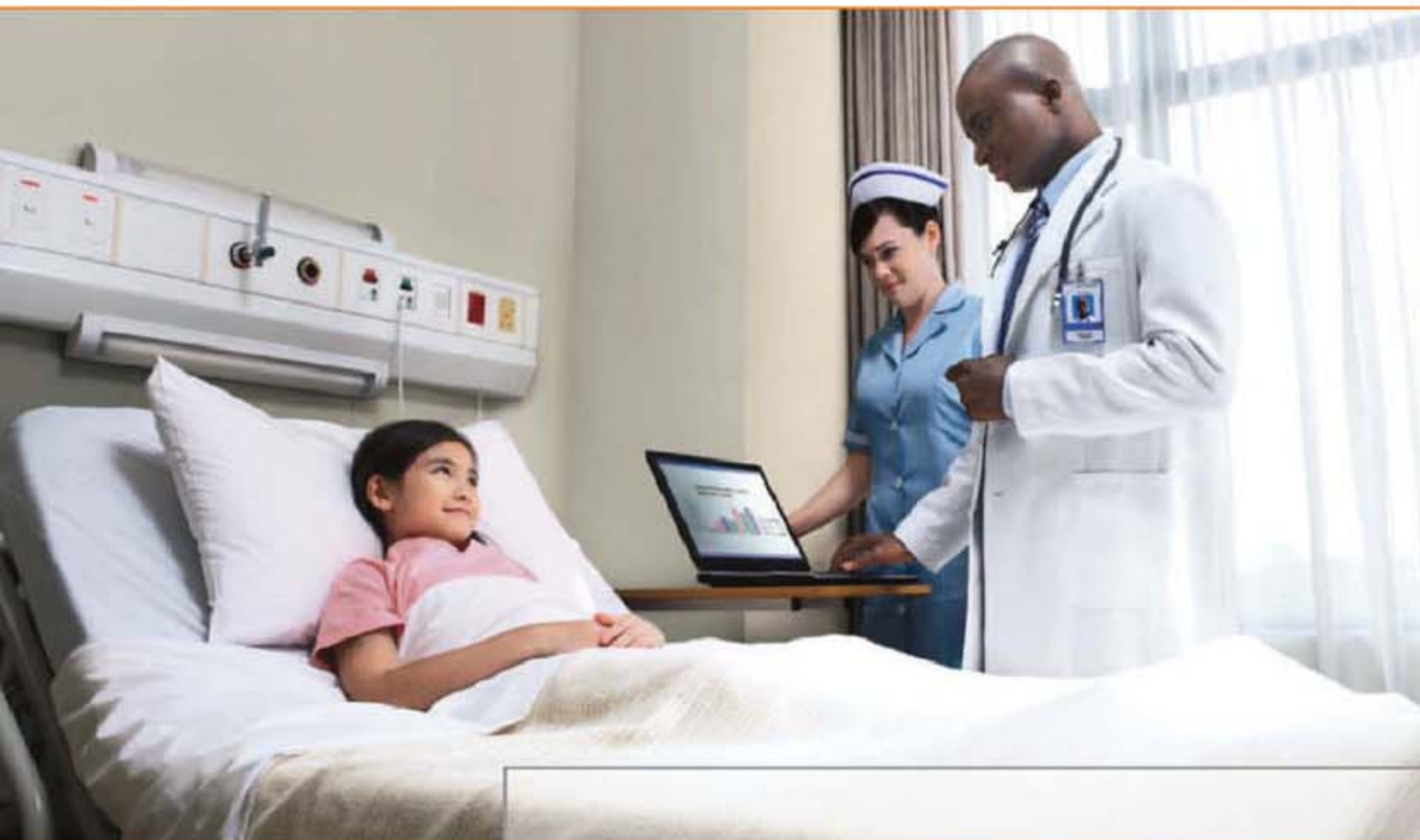
In what may be a harbinger of more pink slips as the financial crisis whacks Silicon Valley, battered online auctioneer **eBay** said on Oct. 7 that it will lay off 1,600 employees, or 10% of its workforce. While that's a reflection of eBay's troubles in its core business, beset by fierce competition from **Amazon.com**, CEO **John Donahoe** also signaled bigger plans for the online-payments business by acquiring a company called **Bill Me Later** and two other outfits for \$1.3 billion. They'll be melded with eBay's lucrative **PayPal** unit.

▶ "Why Bill Me Later Said 'Buy Me Today' to eBay"
businessweek.com/magazine

Protesters near the Nano plant in Singur: Tata gave up and will relocate

\$443,344

The amount AIG spent to host a conference at a California resort just days after getting bailed out



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THIS RECESSION COULD BE MILD BUT LONG

It might be deeper than the downturns of 1990 and 2001 but still gentler than the postwar average—thanks to bold policy actions, falling inflation, and early inventory adjustments

The financial crisis is rapidly moving beyond Wall Street. Frozen credit markets pose a serious threat to the welfare of consumers and businesses—and not just in the U.S. The crisis is now officially global, as evidenced by the unprecedented coordination by major central banks on Oct. 8 to cut interest rates by a half-point. In the U.S., recent reports suggest the economy hit an air pocket last month: Job losses accelerated to a five-year high, and the nation's purchasing managers said manufacturing

activity plunged to a seven-year low. Many economists believe a recession of some depth and duration is unavoidable in the wake of the latest sharp tightening of credit conditions. Worried investors are frozen by one key question: How bad will it get?

Start with past recessions as reference points. On average, the 10 downturns since World War II lasted 10.4 months, and real gross domestic product declined 2% from peak to trough. The last two episodes were relatively mild, each lasting only eight months, with real GDP falling 1.3% in the 1990-91 recession and a mere 0.4% in the 2001 downturn. The average rise in the unemployment rate, from its low point to its peak, was three percentage points.

Against that baseline, there are

several reasons to believe the recession now shaping up will be on the mild side of average, but with the risk that it could be more severe than either of the last two. That's because the financial headwinds facing the economy are without precedent since the 1930s.

The response by Washington policymakers, however, has been equally unprecedented in its magnitude and willingness to break through old policy structures. Congress has ventured outside the free-market mold, committing \$1 trillion this year alone to shoring up the economy and wobbly banks. The Federal Reserve is putting up another \$1 trillion to boost credit-market liquidity via its innovative lending facilities and other means.

The Fed isn't finished. Its latest precedent-busting move is to buy unsecured commercial paper in an effort to thaw the markets for short-term lending, which is crucial to day-to-day business operations. And the Fed's half-point cut in its target rate on Oct. 8, to 1.5%, is likely not its last. Rate cuts will lower banks' cost of funds and over time help to rebuild capital.

The improving inflation outlook gives the Fed leeway to cut further. Market measures of expected inflation have plummeted to levels not seen since the deflation scare earlier this decade. Oil prices are down some 40% since July, and inflation outside of energy and food has declined in every postwar recession, as labor markets

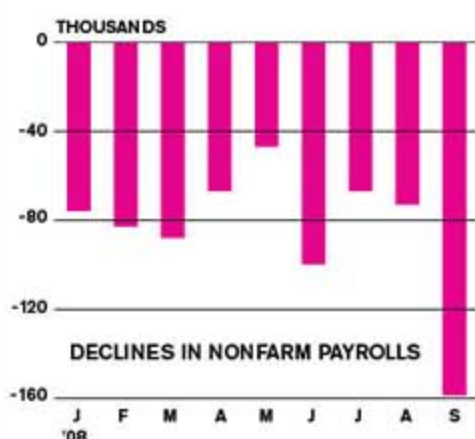
weaken and wage growth slows. The average rise during recession in the unemployment rate, currently at 6.1%, would put peak joblessness at 7.4%.

Another factor that should soften the recession's impact is information technology, which has greatly damped down the inventory cycle. In the 10 previous recessions, efforts to cut excessive inventories have accounted for about 70%, on average, of the drop in real GDP. But new systems have created faster adjustments, especially in this cycle. So businesses already began to liquidate stockpiles in the third quarter of last year. Last quarter's reduction was the second-largest on record.

What may not be so mild about this recession is its length. All four of the monthly indicators used by the National Bureau of Economic Research to date the onset of a downturn began falling between last October and January. Economists are betting the NBER will deem the start date to have been December 2007. That would mean the slump would have to run through April 2009—or 16 months—to tie the severe 1973-75 and 1981-82 recessions for the longest in postwar history. At this point many forecasters think that's not out of the question.

Beyond the current rough patch, history shows recoveries are born of a combination of policy efforts and the economy's built-in recuperative powers. This time should be no different, but that's next year's story. **BW**

THE PACE OF JOB LOSSES ACCELERATED LAST MONTH



Data: Bureau of Labor Statistics, Global Insight

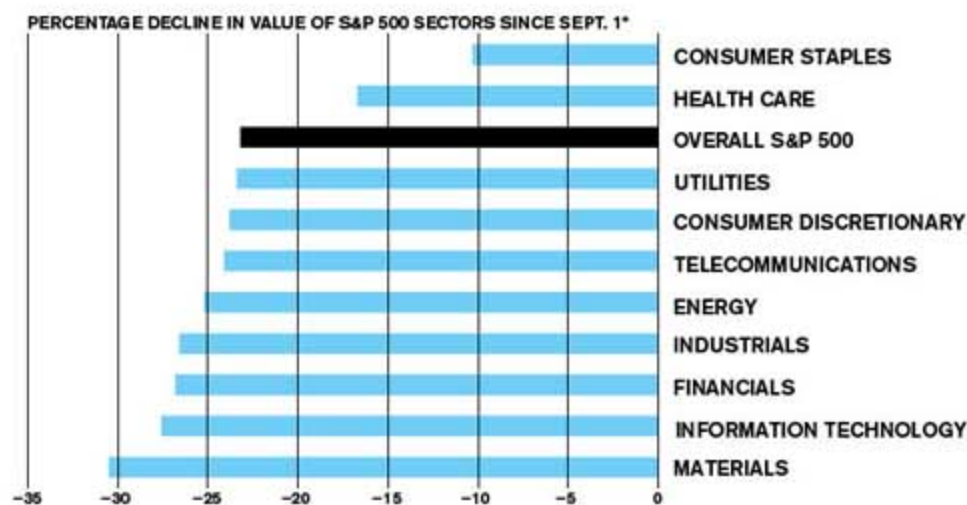
NUMBERS

MARKET TURMOIL: WHERE THE PAIN IS DEEPEST

By Tara Kalwarski/Charts by David Foster

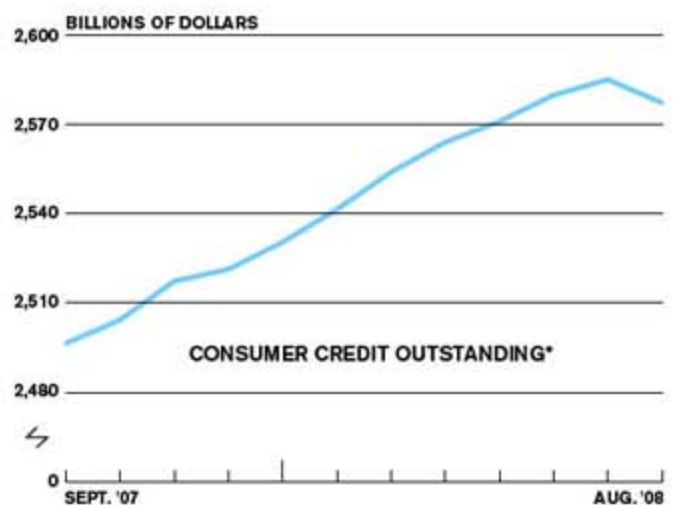
The Standard & Poor's 500-stock index has skidded 23.2% since Sept. 1 amid a continuing housing bust and a consumer credit contraction. And despite emergency actions from global central banks, including the coordinated Oct. 8 rate cuts, panicked investors have driven world markets into a nosedive.

The Carnage: The S&P 500's materials and technology sectors have taken the biggest stock losses since Sept. 1.



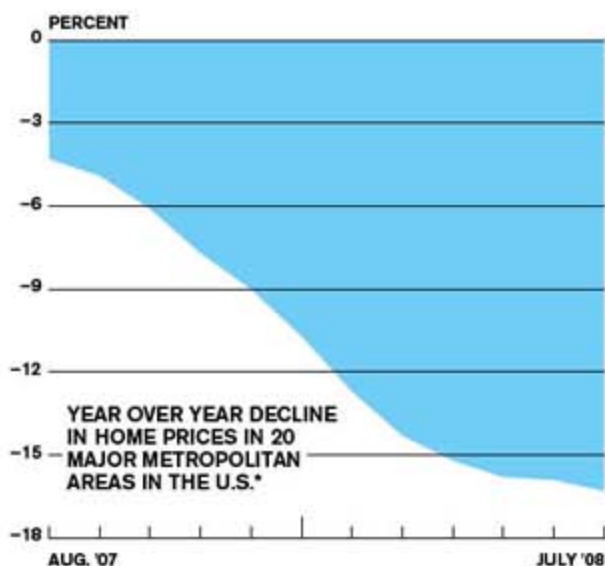
*Through Oct. 8

Consumers Crunched: Non-mortgage debt dropped by a record \$7.9 billion in August.



*Seasonally adjusted

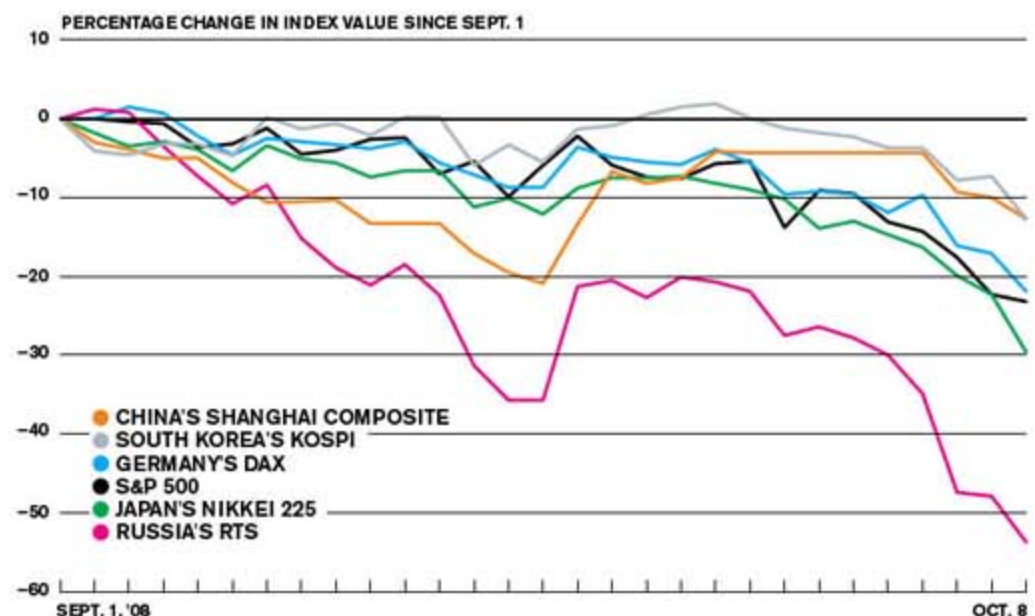
Property Plunge: Lenders are seeing no relief because of still-falling home prices.



*As measured by the S&P/Case-Shiller Composite 20 Home Price Index

Data: Bloomberg Financial Markets

World Markets Whacked: Since Sept. 1 most developed and emerging equity markets have absorbed double-digit losses.





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FANTASY BAILOUT: PICK YOUR TEAM

What do the first U.S. Treasury Secretary and the author of *Charlotte's Web* have in common? Both would be handy to have around in the current financial crisis, according to four experts. We asked each to assemble an economic dream team—people from the past or the present who could help clean up the mess.

JAMES GRANT, *editor, Grant's Interest Rate Observer*

▲ **E.B. White** (1899-1985), the great American essayist and children's book writer, for the clarity of his prose. The trouble with high finance is that nobody speaks English. Jargon defeats clear thinking.

■ **Thomson Hankey** (1805-1893), a Bank of England governor who would drop dead all over again if he could see what the Fed is doing. Hankey opposed the idea that a central bank should lend unstintingly in a crisis. Let every bank look out for itself.

■ **George Gilbert Williams** (1826-1903), longtime president of the old Chemical Bank of New York, where Hetty Green, America's first female tycoon, was a depositor. Asked the secret of his success, Williams replied: "The fear of God." Just the right approach to risk management.

RICHARD SYLLA, *economist and business historian, NYU*

■ **Alexander Hamilton**, the first U.S. Treasury Secretary, who used modern central banking techniques to stem the country's earliest financial crisis in 1792.

■ **J. Pierpont Morgan**, who stepped up to end the Panic of 1907 by buying distressed assets and persuading other bankers to do likewise.

▲ **Franklin D. Roosevelt**, for the New Deal financial reforms that made Wall Street more transparent and accountable.

■ Former Fed chairman **Paul Volcker** and current chairman **Ben Bernanke**, the foremost academic authority on the breakdown of our financial system in the Great Depression.

■ **Warren Buffett**, whose recent investments in iconic companies are helping to restore confidence. As did Morgan, he demonstrates a self-interest that is consistent with financial statesmanship.

FRANK PARTNOY, *corporate law professor, University of San Diego; former Morgan Stanley investment banker*

■ **Ivar Kreuger** (1880-1932), the Swedish-born global financier

and industrialist (the "match king") who operated at the center of the 1920s boom and bust.

▲ **John Kenneth Galbraith** (1908-2006), because he wrote the book on the 1929 crash.

■ **Jim Grant** of *Grant's Interest Rate Observer*, because he's fearless and understands the dangers of financial complexity.

■ Anyone who worked in **Morgan Stanley's derivatives group** in the 1990s—because we saw it coming.

ALICE RIVLIN, *senior fellow, Brookings Institution; first Congressional Budget Office director*

■ **Paul Volcker**, because he is so sensible and has such credibility.

■ **Lyndon Johnson**, because he could make Congress do anything he wanted.

▲ **Alexander Hamilton**, because he would bring on board the people Johnson might fail to persuade.



A CLUTCH OF CRISIS BOOKS

In a flurry of deals, publishers have signed at least three journalists to write about the financial crisis and its aftermath, adding to the works in progress by analyst Barry Ritholtz and writer William Co-han. According to *Publishers Weekly*, advances for the recent deals are rumored to range from the high six figures to over \$1 million. Due dates aren't yet set in some cases, but most of the books should hit stores by 2010. —Ben Levisohn

WRITING THE WRONGS

AUTHOR	TITLE	PUBLISHER/DATE
BARRY RITHOLTZ	<i>Bailout Nation: How Easy Money Corrupted Wall Street and Shook the World Economy</i>	McGraw-Hill Jan. 11, 2009
WILLIAM COHAN	<i>House of Cards: A Tale of Hubris and Wretched Excess on Wall Street</i>	Doubleday Apr. 21, 2009
ROGER LOWENSTEIN	<i>Six Days That Shook the World*</i>	Penguin Press No date set
JOE NOCERA and BETHANY MCLEAN	No title yet	Portfolio No date set
ANDREW ROSS SORKIN	<i>Too Big to Fail*</i>	Viking No date set

*Working title

Data: BusinessWeek

AHEAD BY A GULP

Since Oct. 1 customers at 7-Eleven have been able to choose cup colors for their 20-ounce hot drinks—Democratic blue or Republican red. The convenience store's previous Presidential cup polls, in 2000 and 2004, accurately predicted the winners within a few percentage points, says spokesperson Margaret Chabris. As of Oct. 7 the running tally from 5,375 participating stores (posted at 7-election.com) shows Obama ahead, 58% to 42%. He's also on top (55% to 45%) at BuyCostumes.com, which sells paper Halloween masks of the candidates. Palin, though, is outselling Biden more than 3 to 1. —Aili McConnon



Credit card not maxed out? You still may be a binge buyer

WHEN IT'S MORE THAN A SPREE

Times are tough, but shop they must. Almost 9% of U.S. adults may be compulsive buyers, say researchers at the University of Richmond in Virginia. Marketing professor Nancy Ridgway and her team have developed a new questionnaire to screen for the disorder, previously thought to affect just 5% of the population. The new scale eliminates questions about maxed-out credit and other financial consequences of binge buying. "Many people can afford their habit," says Ridgway. "But spending so much on themselves leaves them

feeling emotionally bankrupt."

The revised test has six questions—three that tap into obsessive-compulsive behavior ("My closet has unopened shopping bags in it") and three relating to poor impulse control ("I buy things I don't need").

The researchers developed and validated the scale using 1,212 participants—in some cases, comparing responses with actual purchase data. While the current credit crunch is unlikely to "cure" the ailment, Ridgway notes, it could lead more people to seek treatment. —Ellen Gibson

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FACETIME

MARIA BARTIROMO



021



BLACKROCK'S PETER FISHER ON WHEN THE PAIN WILL END

As the struggle to contain the worst Wall Street wildfire in decades continues, nonfinancial companies are showing the strains of a constricted credit market. For example, on Oct. 1 billionaire investor Warren Buffett pumped \$3 billion into GE, giving the company a liquidity cushion as lending dries up. And on Oct. 7 the Federal Reserve announced its intention to buy short-term debt issued by corporations after top-rated AT&T was unable to raise money in the commercial paper market. To make sense of what feels like endless economic turmoil, I talked with Peter Fisher, co-head of portfolio management at the investment firm BlackRock, which seems to be sailing through the crisis. Fisher is also a former Treasury Under Secretary for domestic finance and spent 15 years at the Federal Reserve Bank of New York.

MARIA BARTIROMO

How would you describe where we are today?

PETER FISHER

The fourth quarter jumped off with both AT&T and GE not being able to roll over their commercial paper, telling us that two premier names of Corporate America couldn't get the short-term financing they were looking for. That's the most extreme expression of the unwillingness of the financial community to lend. If GE has to sell a piece of itself to roll its short-term credit, other companies are going to find the cost of short-term financing prohibitive.

How long will it take to loosen credit markets up and get stability back?

This fourth quarter is going to be very hard. We just got off to a painful start. It's going to be several quarters from now, the middle of next year.

Are the Fed, the Treasury, and the global central banks headed down the right road, or are they perhaps creating new problems in the rush to shore up world credit markets?

I think there's a dilemma. It's important for them to step in, but it's also important for them to do this in a way that instills confidence in other financial institutions. And that's what we're still struggling with: Where do we start to find a bottom? The Citi-Wachovia, then Wells Fargo-Wachovia deal, that may be a kind of turning point, where Wells Fargo is prepared to step up and say they don't need any government support. We need a few more episodes like that.

Do you worry that as this landscape continues to evolve there's too much concentration of capital?



Fuld in D.C.: He told Congress he was baffled why the feds didn't bail out Lehman

I hope when we come out of this, we don't end up with just a handful of big institutions. I don't think that's actually a likely outcome even though that's what it looks like while we're in the midst of this turmoil. There really are only six businesses in finance: You can write loans, underwrite loans, distribute assets, hold assets on behalf of retail investors or institutional investors, or hold assets on your own balance sheet. It's unlikely that someone really is an efficient competitor in all six businesses. So there's going to be a reorganization. I think we're going to see the industry breaking into these different units. And I think that will be part of what comes about as Washington looks at the question of regulation.

You were an Under Secretary of the Treasury. What should the feds be doing that they're aren't doing, and what are they doing that they shouldn't be doing?

Both the Federal Reserve and the Treasury have got to focus on investor confidence. But they've got to be careful not to roll everything up on the taxpayer and guarantee every investor out there.

"THE AUTHORITIES HAVE GOT TO CLOSE THOSE FIRMS THAT ARE NOT GOING TO BE SURVIVORS.... WE CAN'T WAIT AROUND FOR CONSOLIDATION"

What can they be doing to make people feel confident?

They've got to help sort out the institutions that are going to be survivors and those that aren't. One of the problems has been that when you give a speech or announce that all the banks in America have got to raise capital, you're pre-announcing dilution, and that doesn't do much for the existing equity owner's confidence. It makes them run for the exits. So I think if banks are going to raise capital, you've got to do it really quickly. Goldman Sachs raised capital in a heartbeat.

You don't threaten dilution and therefore upset your shareholders. The other thing is that the authorities have got to close those firms that are not going to be survivors as quickly as possible. We can't wait around for consolidation.

Do you think we will see more bank failures?

I think we're likely to see some banks being closed. It's not just about commercial banks. There are other kinds of lenders that overextended themselves, and they're probably going to be reduced in number, too.

Lehman CEO Dick Fuld said in congressional hearings on Oct. 6 that he would go to his death wondering why the feds did not bail out Lehman. Was letting it go under a mistake?

It was probably a mistake to wind it up the way they did—by announcing it was going into Chapter 11 and then keeping the broker-dealer business open for another week here in the U.S. That may have helped facilitate a winding up of its affairs, but it created more chaos.

By all accounts, New York Fed President Tim Geithner refused to let Lehman recast itself as a commercial bank. But days later, Goldman and Morgan Stanley were allowed to transform themselves. What was his rationale?
I don't know.

How could all of these institutions, run by very smart people, get caught in the same trap?

In the middle years of this decade, we had negative real short-term interest rates. And that really means free money, which really distorts the system. Capitalism is premised on the idea that capital is a scarce commodity rationed with a price mechanism. It wasn't just a handful of clever guys on Wall Street who figured out what to do with the free money. People all over the housing and financial services industries figured out ways to lever themselves up way too far. That's the engine that led us this far astray. **| BW |**

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

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THE CREDIT-CARD BLOWUP AHEAD

A payload of troubled debt is about to explode, hurting banks such as BofA and JPMorgan that have largely dodged the mortgage mess

By Jessica Silver-Greenberg

The troubles sound familiar. Borrowers falling behind on their payments. Defaults rising. Huge swaths of loans souring. Investors getting burned. But forget the now-familiar tales of mortgages gone bad. The next horror for beaten-down financial firms is the \$950 billion worth of outstanding credit-card debt—much of it toxic.

That's bad news for players like JPMorgan Chase and Bank of America

that have largely sidestepped—and even benefited from—the mortgage mess but have major credit-card operations. They're hardly alone. The consumer debt bomb is already beginning to spray shrapnel throughout the financial markets, further weakening the U.S. economy. "The next meltdown will be in credit cards," says Gregory Larkin, senior analyst at research firm Innovest Strategic Value Advisors. Adds William Black, senior vice-president of Moody's

Investors Service's structured finance team: "We still haven't hit the post-recessionary peaks [in credit-card losses], so things will get worse before they get better." What's more, the U.S. Treasury Dept.'s \$700 billion mortgage bailout won't be a lifeline for credit-card issuers.

The big firms say they're prepared for the storm. Early last year JPMorgan started reaching out to troubled borrowers, setting up payment programs and making other adjustments to ac-

counts. "We have seen higher credit-card losses," acknowledges JPMorgan spokeswoman Tanya M. Madison. "We are concerned about [it] but believe we are taking the right steps to help our customers and manage our risk."

But some banks and credit-card companies may be exacerbating their problems. To boost profits and get ahead of coming regulation, they're hiking interest rates. But that's making it harder for consumers to keep up. That'll only make tomorrow's pain worse. Innovest estimates that credit-card issuers will take a \$41 billion hit from rotten debt this year and a \$96 billion blow in 2009.

Those losses, in turn, will wend their way through the \$365 billion market for securities backed by credit-card debt. As with mortgages, banks bundle groups of so-called credit-card receivables, essentially consumers' outstanding balances, and sell them to big investors such as hedge funds and pension funds. Big issuers offload roughly 70% of their credit-card debt.

But it's getting harder for banks to find buyers for that debt. Interest rates have been rising on credit-card securi-

WHO'S AT RISK?

The credit-card issuers that stand to lose the most if the industry stumbles

	AMOUNT OF CREDIT CARD DEBT (\$BILLION)	PERCENT OF REVENUE FROM CREDIT CARDS*
JPMorgan Chase	155.4	20.5
Bank of America	153.3	22.1
Citigroup	151.2	15.7
Capital One	67.8	62.0
American Express	64.7	24.5
Discover	47.0	97.8

*U.S. credit cards only
 Data: Innovest



ties, a sign that investor appetite is waning. To help entice buyers, credit-card companies are having to put up more money as collateral, a guarantee in case something goes wrong with the securities. Mortgage lenders, in sharp contrast, typically aren't asked to do this—at least not yet. With consumers so shaky, now isn't a good time to put more skin in the game. "Costs will go up for issuers," warns Dennis Moroney of the consultancy Tower Group.

Sure, the credit-card market is just a fraction of the \$11.9 trillion mortgage market. But sometimes the losses can

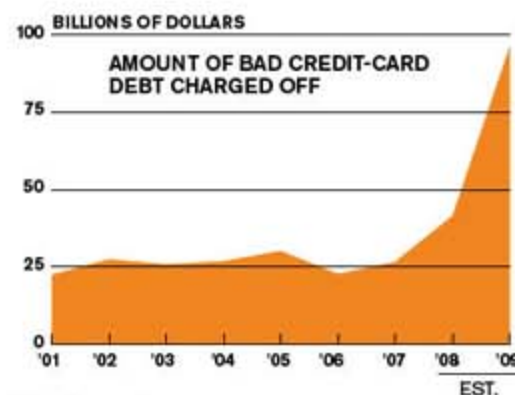
be more painful. That's because most credit-card debt is unsecured, meaning consumers don't have to make down payments when opening up their accounts. If they stop making monthly payments and the account goes bad, there are no underlying assets for credit-card companies to recoup. With mortgages, in contrast, some banks are protected both by down payments and by the ability to recover at least some of the money by selling the property.

THE BIG BOYS' BURDEN

Making matters worse, the subprime threat is also greater in credit-card land. Risky borrowers with low credit scores account for roughly 30% of outstanding credit-card debt, compared with 11% of mortgage debt. More than 45% of Washington Mutual's credit-card portfolio is subprime, accord-

BAD DEBT

The pile of rotten credit-card debt is mounting



Data: Innovest

ing to Innovest. That could become a headache for JPMorgan Chase, which agreed on Sept. 25 to buy the troubled thrift's credit-card business and other assets for \$1.9 billion. Says a JPMorgan spokeswoman: "We are aware of the credit quality of [WaMu's] portfolios and will manage risk appropriately."

Credit-card losses are already taking a bite out of lenders' balance sheets. Bank of America, the nation's second-largest issuer behind JPMorgan, revealed on Oct. 6 that roughly \$3 billion of its \$184 billion credit-card portfolio has soured, a 50% increase from a year ago. At the same time the bank, which is also dealing with the broader financial tumult, said it would have to cut its dividend by 50% and raise \$10 billion in fresh capital. The stock stumbled more than 25% the next day when investors largely scoffed at the new shares BofA was offering. "The good news for us is that we have the strength to get through this, but the bad news is that the earnings recovery does take a while," says BofA spokesman Bob Stickler. "We are prudently adjusting our underwriting standards to adapt to changing economic conditions."

Likewise, American Express, which caters to wealthier borrowers, upped its provisions for credit-card losses from \$810 million to \$1.5 billion in the latest quarter, a sign that even upscale consumers are having trouble. "We have enhanced our credit models and continue to prudently manage our risk by scaling back some card acquisition efforts and reducing credit lines where appropriate," says an

AmEx spokeswoman.

The industry's practices during the lending boom are coming back to haunt many credit-card lenders now. Cate Colombo, a former call center staffer at MBNA, the big issuer bought by Bank of America in 2005, says her job was to develop a rapport with credit-card customers and advise them to use more of their available credit. Colleagues would often gather around her chair when she was on the phone with a consumer and chant: "Sell, sell." "It was like *Boiler Room*," says Colombo, referring to the 2000 movie about unscrupulous stock brokers. "I knew that they would probably be in debt for the rest of their lives." Unless, of course they default.

Responds BofA spokeswoman Betty Riess: "The allegations do not reflect our practices. The bank has nothing to gain by extending credit to people who do not have the ability to pay us back."

Now regulators and politicians are trying to curb some of the industry's abusive practices by limiting interest rate hikes, abolishing certain fees, and



Polemeni's interest rate jumped to 30% after a missed payment

cracking down on questionable billing practices. Under rules proposed by the Federal Reserve, a borrower would have a 21-day grace period before being hit with a late fee, instead of the few days offered by some firms now. A similar plan working its way through Congress would allow banks to increase rates only on consumers' future purchases—not existing balances. And under both proposals, credit-card companies would have to allocate account holders' payments equally to balances with different interest rates. Currently, firms first apply payments to the debt with the lowest rate, which means it takes longer and makes it costlier for consumers to pay off their debt.

LAST HURRAH

The Senate isn't expected to vote on the matter until early next year. The Fed's rules, currently being reviewed by the industry, could take effect around that same time. But lenders seem to be preparing for the worst-case scenario: an outright ban on some practices.

To get ahead of rules that would hamper their ability to reprice accounts, for example, many firms are jacking up interest rates. A survey of major issuers by consumer advocacy group Consumer Action found that 37% of firms have raised rates across the board, even for borrowers with relatively pristine

credit records. "In anticipation of a federal crackdown, card companies are scouring their portfolios and tightening credit," says Tower Group's Moroney.

Even consumers like Michael Polemeni, who miss only a single payment, can find themselves in the crosshairs of credit-card companies. The independent computer specialist relied heavily on his credit cards for child support payments and business expenses. Polemeni generally made more than the minimum payment each month, carrying a \$2,000-or-so balance. But in July he missed a payment, and Provident, owned by Washington Mutual, jacked up his rate from 9% to 30%. "I was shocked because I am a very good customer," says Polemeni, who paid off the full balance immediately. WaMu didn't return calls for comment.

Not everyone will be able to pay down their debts like Polemeni. And that could make for a vicious cycle: As credit-card companies raise rates, more consumers fall behind on their payments, which then hurts the issuers. Says Innovest's Larkin: "We are going to see the banks massively hit." | BW |

Business Exchange

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Emerging Markets Gorge on Plastic

Consumers in Latin America, South America, and Eastern Europe are filling their wallets with credit cards. The number of cardholders in Brazil and Mexico has more than doubled in the past three years. But rapidly rising credit-card debt can wreak havoc on emerging-market economies, according to Oxford Analytica. Take South Korea. Consumers there went overboard on credit in 2003 and defaulted on a large percentage of those loans—which seriously crimped the country's growth.

To read the Oxford Analytica article, go to <http://bx.businessweek.com/credit-card-industry>

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HOW TO STOP THE PANIC

It is possible to calm the waters, but it'll mean unlearning our post-Depression lessons

By Peter Coy and Stanley Reed

The world's governments are shocked and dismayed by their inability to stop the increasingly grave financial crisis. Nothing they have attempted has gotten lending flowing normally. Profitable companies are cut off from borrowing. Confidence is shot. Through Oct. 7 the U.S. stock market had its worst five-day performance since 1932 on fears of a severe economic downturn. Says Stephen Jen, currency economist at Morgan Stanley in London: "The choices for the real economy are between a recession and a depression."

Can anything be done to halt this panic? As a matter of fact, yes. It won't be quick or easy. But the prerequisite for a new approach is unlearning doctrines that were developed in the aftermath of the Great Depression, the last time financial conditions were worse than this. The world has changed in the intervening seven decades, and what worked to quell the financial crisis then may not work now—as anyone trying to borrow money can see.

So far, crisis managers in the U.S. and abroad have relied mostly on using "helicopter money"—that is, dropping dollars across the financial landscape in hopes of reviving lending

and spending. Generations of mainstream economists around the world learned this approach at the feet of the late Nobel laureate economist Milton Friedman, who coined the helicopter metaphor. Federal Reserve Chairman Ben Bernanke, while parting from Friedman in some particulars, shares his general approach—and in fact earned the moniker "Helicopter Ben" after citing Friedman's coinage in a 2002 speech.

Following this logic, the Federal Reserve is aggressively lending money to all comers. The synchronized international rate cuts on Oct. 8—which lowered the U.S. federal funds rate to just 1.5%—is another example of helicopter money. Central banks figure that by flooding the banking system with reserves, they can get banks to relend the money to the rest of the economy. But while lowering interest rates and providing liquidity is essential, it's no longer enough, says Paul J.J. Welfens, president of the European Institute for International Economic Relations in Wuppertal, Germany. Says Welfens: "It's very dangerous if you don't have

a strategy. The situation is worsening because no one is doing a [basic] program to restore confidence."

An alternate approach that's gaining favor in many quarters is to place money strategically where it can do the most good, even if that means picking winners and losers and allowing some channels of credit to dry up for the time being. One tactic: direct government investments in selected banks on a large scale. The theory behind this approach is that the banks are so wounded that simply lending them more money won't solve anything. To restore their positive net worth so they



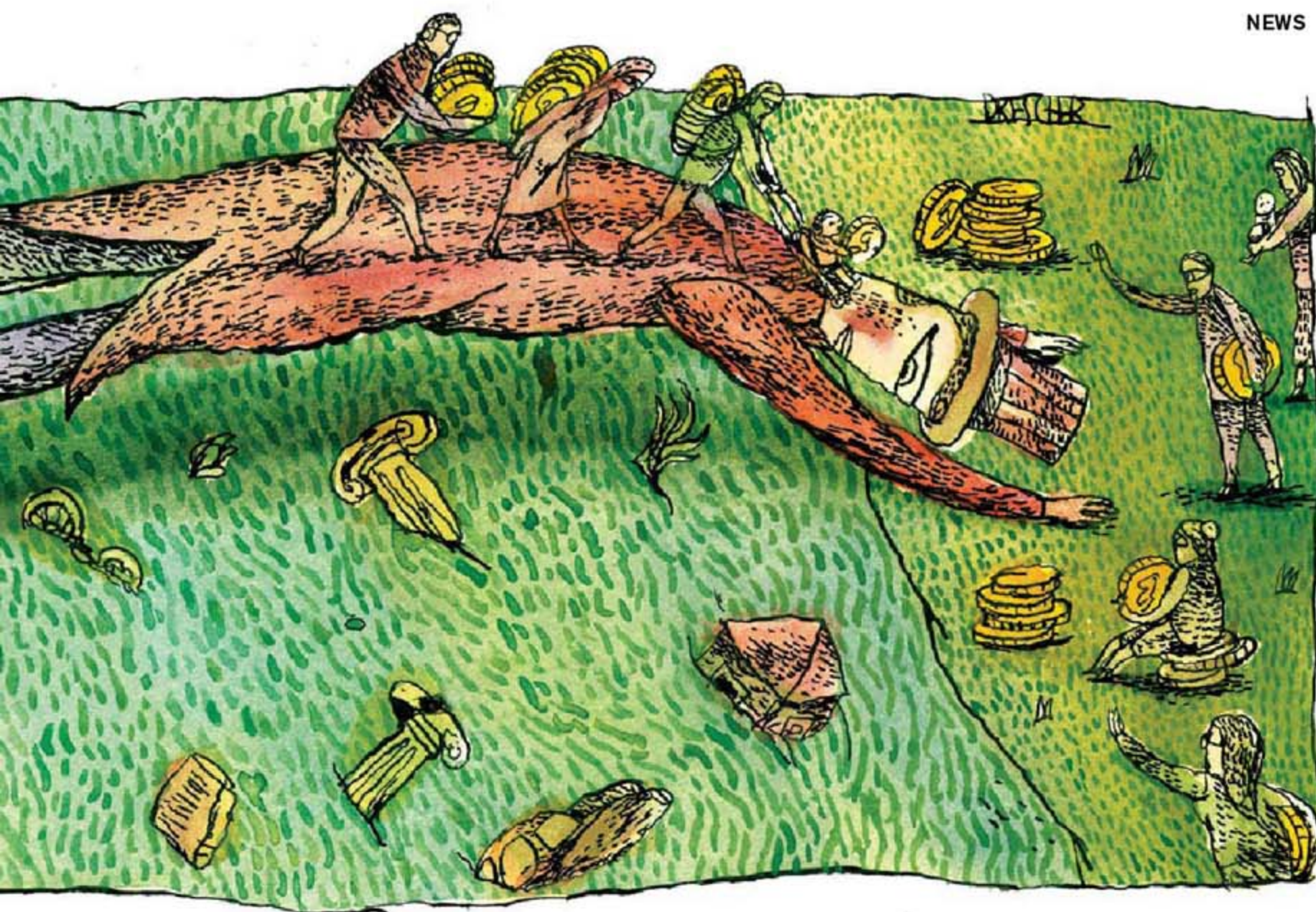
HENRIK DRESCHER

PULLING OUT THE STOPS

The government has steadily broadened its role to safeguard the economy from the credit crisis. Here are some important milestones:

Data: BusinessWeek

DATE	DEC. 11, 2007	MAR. 16, 2008	SEPT. 7, 2008
TARGET	COMMERCIAL BANKS	WALL STREET	MORTGAGE FINANCE
WHAT GOVERNMENT DID	The Federal Reserve begins lending to banks for longer than overnight. By October 2008, many banks are on Fed life support.	The Federal Reserve starts lending money to Wall Street firms that are primary dealers in Treasuries.	The Federal Housing Finance Agency puts Fannie Mae and Freddie Mac into conservatorship.



can lend freely, banks need fresh equity, and government is the only party that's capable of providing it in these extreme conditions. Sweden used this strategy to end a banking crisis in the early 1990s. And on Oct. 8, Britain took a giant step in the same direction, announcing an offer to buy up to \$88 billion worth of preferred shares in Britain's biggest banks. The government also said it would guarantee up to \$437 billion of the banks' debt. "This is beginning a process of [undoing] a big problem where banks won't lend to each other for long periods," Chancellor Alistair Darling told Sky News.

On Oct. 8, U.S. Treasury Secretary Henry Paulson broadly hinted that Washington is likely to use a targeted approach with at least some of the \$700 billion authorized by Congress to deal with toxic mortgage-backed securities and other assets—including buying equity shares in some financial institutions.

A targeted approach doesn't waste money on weak banks that deserve to disappear. "You are going to see significant consolidation in banking across Europe. As the tide goes out, the weak models and weak managements are revealed," says Robert E. Diamond Jr.,

president of Barclays, the British banking company. More policymakers and economists are coming around to approaches such as Britain's because of the manifest failure of loans, guarantees, and asset purchases to get the job done. In fact, an unhealthy dynamic has developed. The Fed and other central banks have steadily expanded the portions of the economy to which they are lending freely—in effect, declaring them to be protected within the walls of the fortress. But it's having unintended consequences.

Central bankers' desperate extension of credit to new kinds of borrowers simply worsens the condition of solvent institutions left outside the walls, because investors and lenders pull money out of them. That explains the wild swings in stock prices and credit spreads. For example, the branches of British-owned banks in Ireland lost money to locally owned rivals after Dublin offered blanket protection on all deposits of Irish-owned banks there. And in the U.S., corporations that borrow in the commercial

SEPT. 17, 2008	SEPT. 19, 2008	SEPT. 30, 2008	OCT. 7, 2008
INSURANCE INDUSTRY	MONEY MARKET FUNDS	FINANCIAL SECTOR	ALL CORPORATIONS
The Fed makes an \$85 billion, two-year loan to American International Group and gets warrants for a majority stake.	Treasury offers insurance to money market mutual funds, which help corporations and local governments by buying their debt.	Congress passes the bailout bill, which authorizes Treasury to buy up mortgage-backed securities from banks.	The Fed says it will buy commercial paper from issuers, thus providing direct financing to banks and corporations.

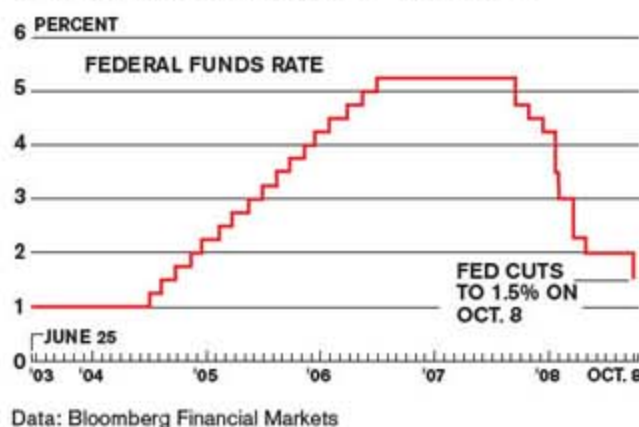
paper market were cut off from funding because investors moved to safer Treasuries—forcing the Fed to say on Oct. 7 that it would step in to buy the commercial paper itself. The logical endpoint of this game is for governments to protect all financial assets. That's an awfully Big Government outcome for an approach that started out with a small-government thrust.

MORAL HAZARD

U.S. policymakers have sometimes departed from the helicopter-money approach, as in the rescues of Fannie Mae, Freddie Mac, and American International Group, which gave the government big equity holdings. They may need to jettison another bit of orthodoxy, which is that it's dangerous to make explicit promises of taxpayer support for fear it will encourage risky behaviors. Economists have long been taught to avoid creating "moral hazard"—giving people an incentive to take big risks. Letting Lehman Brothers fail was intended to send a warning to risk-takers. But by trying so hard to

THE FED CUTS

The Federal Reserve has had to retract almost all of the rate hikes it made since 2004



avoid moral hazard, governments aren't giving markets the confidence they need, says Richard Portes, an economist at the London Business School, adding: "In circumstances like this, the last thing you want is ambiguity."

The longer the banks are incapacitated, the worse the damage to the real economy. "Banking institutions are really the rock foundation of all of the economic activity that occurs,"

says Edward Liebert, who is treasurer of Philadelphia-based chemical maker Rohm & Haas as well as chairman of the National Association of Corporate Treasurers. Policymakers are getting the message. "Generally speaking, central banks and governments are just beginning to understand the severity of the crisis and how it impacts on their economies," says Donald Moore, chairman of Morgan Stanley in Europe. "My view is we are going

to take another three to six months to sort this." It may take that long for the generals to learn how to fight this war, not the last one. **| BW |**

— With Jack Ewing in Frankfurt

BUSINESSWEEK.COM | For a discussion on what it's going to take to stop the panic in the credit markets, watch a video report at www.businessweek.com/go/tv/panic

RAY VELLA/BW

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