1. FUN AND GAMES

Ask Pat Dunlavy to give you the defining moment of his long career at Salomon Brothers—the point in time when he started to *really* understand how the firm and the rest of Wall Street really works—and he'll tell you the story about "The Great Race of 1978."

Dunlavy was thirty years old. He was making a good living as a bond salesman in Salomon Brothers' Cleveland office. His customers were predominantly large pension funds and other institutional investors in the Midwest that bought and traded bonds. Because of his position, he had contact with some of the firm's power players in New York, including the firm's legendary CEO, John Gutfreund, and some of the most savvy bond traders he'd ever met, people such as Lew Ranieri and a brilliant and charismatic trader named John Meriwether, known throughout the firm simply as "J.M."

The Cleveland office occupied one of the largest buildings in Cleveland, fourteen stories overlooking a decaying downtown of abandoned buildings and steel mills. Like most securities firms, Salomon Brothers had its share of loudmouthed former jocks, particularly at its sales and trading desks. Daniel Benton, a salesman and former high school football player, was one of those (though certainly not the worst bloviator of the bunch). Benton was growing tired of being ribbed about his expanding waistline. At one point he made an officewide announcement. He challenged anyone in the office to a race up the building's fourteen floors. He said he would wipe the floor with any one of them.

Dunlavy, a former college football player, had been working out regularly. One afternoon he approached Benton. "You really want to race up all fourteen stories?" Benton said he did, and if Dunlavy was man enough, he should meet him downstairs in two weeks, just before the firm's Saint Patrick's Day celebration, and race him to the top.

"And get ready to lose," he added with a smirk.

But what started out as a prank between two over-the-hill football players in Salomon's Cleveland office grew into something much bigger. The office manager invited some of the office's biggest clients to watch. Employees brought their wives. News of the "great race" even spread to Salomon's New York office. Traders were now laying odds on which one of the guys would win or which of them would drop dead of a heart attack before making it to the top.

It was then that Dunlavy received a call from Meriwether. In 1978, John Meriwether hadn't yet achieved his notoriety through his depiction in Michael Lewis's book *Liar's Poker*, but his legend was growing. Most firms on the Street specialized in providing advice, to either companies or individual investors. Not Salomon Brothers. Its specialty was trading, and not just stocks but bonds as well. Because of high inflation, which eats away at the value of these so-called fixed-income investments, the bond market was a backwater during most of the 1970s. They were sold primarily to people who held them until they "matured" so they could collect regular interest payments.

But to traders at Salomon Brothers, the bond market was a big casino where they were the only real players. In the New York office, Lew Ranieri was perfecting a relatively new type of bond known as the mortgage-backed security—essentially a pool of mortgages in which the investor is paid an interest rate that flows from the mortgage payments of home owners (more on this in a bit). John Meriwether was just in his early thirties when he made his first major score on what was then considered a big gamble: buying New York City municipal bonds at the height of the city's fiscal crisis.

Those were the years of high crime and white flight; the city nearly defaulted on its short-term debt. Real estate prices were falling. People were afraid to ride the subways. President Gerald Ford told the city to drop dead. But Meriwether saw the city's promise and began snapping up its debt on the cheap. He took a calculated risk on New York, and his calculations were right on the money.

By the late 1970s Meriwether was taking even bigger risks. He was now part of the firm's newly created bond arbitrage desk, a unit of the firm that he headed and grew into a money machine. Bond arbitrage is a more complex form of trading than simply buying New York City municipal bonds at depressed levels; it involves trading various types of bonds and taking advantage of price differences when market conditions change. A spike in

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interest rates can cause government bonds to fall because of inflation fears but corporate bonds (particularly junk bonds) to rise because inflation may spur economic growth, which in the eyes of investors may make corporate debt more appealing. The trick is to guess which markets will fall and which will rise and place your bets accordingly. It's a high-reward but high-risk business; tens of millions of dollars can be made or destroyed in the blink of an eye.

Meriwether was one of the best arbs at Salomon, maybe on all of Wall Street. He was a math genius with a penchant for gambling, something he had been doing since he was a kid growing up on the South Side of Chicago.

When J.M. called, there wasn't much small talk, and today's call was no different. Meriwether said he wanted to know everything he could about the great race. He wanted precise details about Dunlavy's weight and height and Benton's as well. He asked questions about the building and if Dunlavy had been training for the event. Dunlavy said he had. He asked if Benton had been training. Dunlavy said he doubted it. "He's so confident he's going to win, he thinks he doesn't have to train," Dunlavy said.

"So will you beat this guy?" Meriwether asked.

"Absolutely," Dunlavy shot back. "If I can't drag my sorry ass up those stairs faster than Dan, I'll shoot myself!" Dunlavy said he also had some money on the line; he'd bet Benton $50 he would win.

After a pause, Dunlavy asked, "Why do you care about any of this?"

"I might want to get involved," Meriwether answered cryptically. "Let me think about it."

Dunlavy wasn't sure what the hell "get involved" meant, but a few days later Meriwether called again. He told Dunlavy he was now the official bookmaker for the great race. He was posting a "line," laying odds on who might be the favorite to win and taking bets from anyone in the organization, from traders to back-office personnel. Meriwether said he wanted to make big money off the great race.

Dunlavy wasn't totally surprised. He'd always viewed the typical trader as a gambler with a college degree. The best traders, however, are more like bookmakers—they use information to lay odds on favorites and underdogs. They arrange odds in their favor based on information that you can't get

anywhere else. Meriwether was the best bookmaker on Wall Street and now in the most literal sense: he had been fielding bets for days. The firm as a whole believed the race was Benton's to lose. But based on what he'd heard from Dunlavy, Meriwether believed Benton couldn't possibly win.

Meriwether smelled money; he knew he could make a killing by getting as many people as possible to bet on Benton. To do that, he made Dunlavy the favorite and gave Benton the "spread," a bookmaker's term for extra points. In other words, those who bet on Dunlavy would have to cover the spread—Dunlavy would have to win by several seconds instead of just one. The trick was finding the right spread, one that would attract enough dumb money to bet on Benton.

And that's what Meriwether was focused on now, just as focused as he would be on figuring the odds of one of his most complex trades. "How many seconds do you think you can beat him by?" Meriwether asked.

"Well, it's hard to say," Dunlavy said. "I would guess ten seconds or so."

"Really?" Meriwether fired back. "How confident are you of that number?" Dunlavy said he had run up the stairs once already and finished in 73 seconds. Benton was an overweight ex-jock with bad knees. He'd barely finish, Dunlavy assured Meriwether.

"Okay, then," Meriwether snapped. "I'm going to let the word out that I'm taking you and giving Dan six seconds—I'll take all comers." After a long pause he told Dunlavy, "Don't let me down."

Dunlavy wasn't sure what he'd gotten himself into. He had been working at Salomon's Cleveland office for three years and had dreams of making it to the big time and working out of New York. Meriwether was a rising star in the company, a favorite of Gutfreund and the firm's powerful executive committee. In other words, the last thing he wanted to do was let Meriwether down.

In the coming days, Dunlavy continued to train. He did a couple more trial runs up the fourteen flights and heard through the company grapevine that Meriwether was taking in some fairly big bucks—not the multimillion-dollar trades he made on the bond desk but enough cash to make people realize he could win or lose serious money on the outcome of the race.

Dunlavy knew Meriwether loved to win money, but he also knew that for Meriwether, winning wasn't just about the money. Like any good trader, Meriwether was looking to make a point, and no doubt he wanted to prove to his bosses, his colleagues, and himself that he understood risk and odds better than them all.

Dunlavy remembers the day of the great race well. He wore green gym shorts and a yellow shirt with "THE GREAT RACE" lettered on the front. Benton wore white gym shorts and a blue-and-gray Georgetown University sweatshirt. After many photos were taken, a coin was tossed to see who would run first. Dunlavy won first dibs. At the command, he raced up the first seven floors pretty easily, and then, despite all the training, fatigue started to set in. When Dunlavy finally reached the top floor, he was gasping for air. His wife, Daryl, attended the event and stood over him as he collapsed across the finish line, worried he might have a heart attack.

Benton didn't fare much better, collapsing as he made it across the finish line as well.

A minute later, the results were announced over the "squawk box," the firmwide communications system where research calls and other important messages were announced. "Ladies and gentlemen, the Great Race has just concluded. The times are—Pat Dunlavy, sixty-six seconds . . . Dan Benton . . . seventy-four seconds . . . Happy Saint Paddy's to you all!"

There were many groans but a few cheers all over Salomon country.

Meriwether was one of those cheering. Dunlavy had covered the spread by two seconds. Before the day was over, J.M. called Dunlavy to congratulate him. Dunlavy had now recovered, but barely; it completely slipped his mind to ask Meriwether how much money he had won.

Pat Dunlavy is now retired from Salomon Brothers. During his twenty-three years at the firm, he saw it all: scandals, massive trading losses, huge paychecks, boardroom battles, and ultimately the firm's demise, when, in 1997, Salomon Brothers was purchased by the financier Sandy Weill on his way toward creating another fabled and ultimately troubled financial powerhouse, Citigroup. But through it all, Dunlavy looks back on the Great Race and concedes it taught him something about the culture of Salomon and Wall Street.

In a few years' time, he would be working in New York alongside Meriwether, Ranieri, and Gutfreund. They were all legends of Wall Street—and enormously rich, earning millions of dollars a year in salary and bonuses. They were successful because they were smart, of course. But they had something else going for them: the will—or, to be more precise, the desire—to take risks and gamble.

Most of it was with other people's money, which made the losses more palatable, although all of them had some skin in the game. But risk taking was an obsession at Salomon Brothers, particularly among the new breed of traders and managers during the late 1970s and early '80s, people like Meriwether and Ranieri and others who would fill the trading floor of every big Wall Street firm for the next three decades.

A good case could be made that the success of Salomon Brothers and its bond traders led to a broader revolution that swept Wall Street and sowed the seeds of the financial meltdown of 2008. Historically, and continuing through the 1960s and most of the 1970s, the big firms and partnerships that dominated Wall Street employed a business model that was decidedly low risk, focused mainly on selling advice to investors and large companies.

Things started to change as several forces began to converge. One was money—to be more exact, other people's money. As the big Wall Street firms converted from private partnerships to public companies in the 1980s, they were gambling no longer with their own money but with that of public shareholders, and literally overnight the bets got bigger and the use of borrowed funds, known as leverage, grew and grew. Another was the cost of maintaining the old business model of acting as an "agent" for customers, underwriting corporate stock and bond deals, and selling stocks to small investors. It simply didn't pay as competition caused fees to shrink dramatically beginning in the early 1980s and continuing for the next three decades.

Yet another was technology. As soon as the first computers made their way to the Street, traders began using technology to spit out information about markets and securities, to find historical patterns in the way markets behaved and crunch data in ways that would have been impossible just a few years earlier. Armed with this information, traders for the first time seemingly had a real edge; they could process enormous amounts of information to predict trends and prices and how they repeated over time.

This is the story of how those forces, combined with the very human elements of greed and lust for power, transformed Wall Street over a quarter century and set the stage for the meltdown of 2008 that led to what many economists believe is the worst economic crisis since the Great Depression. There were other factors that contributed to the financial mayhem that reached its peak in the fall of 2008: risk takers such as Meriwether, Ranieri, and the traders they spawned would take over the management of

the big financial firms; the government would entice Wall Street to innovate and create new types of debt on one hand and provide aid and comfort to the risk takers to trade these newly created bonds on the other; regulators such as Fed Chairman Alan Greenspan, as well as various chairmen of the Securities and Exchange Commission, appointed by Republicans and Democrats alike, bowed to pressure from the banking industry, made it easier to take enormous risk, and, despite periods of market unrest, never forced Wall Street to adopt more restraint.

The Ronald Reagan–era tax cuts spurred the economy and the stock market to new heights. But it was Fed Chairman Paul Volcker's policy of squeezing inflation—one of the great economic achievements of our time—that spurred the bond market and made the taking of risk through trading various forms of debt and derivatives of debt the Wall Street business model for the next three decades.

With inflation tamed, lower interest rates in the early 1980s meant cheaper borrowing rates; risk wasn't just made easier by technology, it was now cost effective. Lower borrowing rates meant that speculators could borrow more—a concept known as "leverage"—and put less of their own money down when trading in the open market. Because bonds had become cheaper to sell, companies would rather sell debt if they needed to raise cash than dilute current stockholders' holdings by issuing additional shares to the public.

Wall Street began inventing new bonds—one was the junk bond, another was known as the mortgage-backed security—and the various iterations of each would reach massive proportions. Mortgage bonds would prove particularly enticing for Wall Street because of the massive fees generated in the creation of these securities and because of the alleged social good they created. In its simplest form, the mortgage-backed security is nothing more than a bond packed with mortgages; payments are funneled from the mortgage holder to the bondholder. The objective: to get banks to take the loans off their books and sell them to Wall Street, which would then sell them to investors so the banks could keep making more loans.

All the bonds could be traded. Liquidity is the lifeblood of any market, and as interest rates fell, bond trading exploded. As bonds were traded and commoditized, profit margins naturally shrank, as they had in the

old-line businesses of underwriting and providing advice to small investors. That forced Wall Street to innovate further. New types of bonds were created—"derivatives" of the old bonds. The bonds became more complex and packed with riskier mortgages, for which home buyers paid higher rates of interest that were funneled through to investors, who demanded higher yields. The trades became more complex and larger, based on computer models that allegedly reduced risk to the bare minimum. Where would it all end? No one seemed to care. Money was being made, and no one seemed to think that someday it all might end. And just like that, Wall Street's business model had shifted from giving advice to taking on risk.

Young MBAs working on Wall Street no longer wanted to advise CEOs how to run their businesses; they wanted to use leverage to take over the companies, restructure their operations, and sell them at a profit.

Evaluating and taking risk were now necessary ingredients of working on Wall Street. Brokers didn't make big bucks by recommending to their clients some supersafe long-term investment; they made their fortunes by churning the accounts of their best customers, essentially trading shares that didn't need trading in order to generate commissions. Bankers didn't buy their second homes in the Hamptons simply by telling a company how to manage its cash flow; the trick was to get the typical CEO in the 1980s to grow a company by acquisitions, often by using debt to finance the deal.

Traders didn't receive $10 million bonuses because they were completely hedged against endless losses; they made money by weighing the odds and then making decisive, and massive, bets.

And they made those bets because they were now in their comfort zone of risk taking. The randomness of events meant little to this new breed of executive on Wall Street; even as the markets grew more complex and the stakes got higher with wild market swings, a concept known as volatility, risk continued to dominate the Wall Street mind-set. In the new world of Wall Street, randomness was a friend because it increased the odds of making the ultimate payday even bigger, even as it increased the odds of losing.

Pat Dunlavy was now discovering this firsthand. Dunlavy had come a long way from the "Great Race" in Cleveland; by 1983, he was working for Salomon's number two executive, Tom Strauss. Given the specula-

tive nature of their business, Dunlavy was most proud that the business didn't lose any money.

"Tom, we had a pretty good quarter," Dunlavy said. "We cut back on our risk position dramatically. We're in great shape, and most of all we haven't lost any money. It's amazing!"

Dunlavy was expecting promises of a big bonus, drinks at the end of the day, or at the very least a gold star on the lapel of his suit. What he got, instead, was a bucket of cold water thrown right in his face. "Well, if you're telling me you haven't had a loss yet, that doesn't make me happy. All that means is you're not taking enough risk."

Dunlavy was floored. It was a speech he would have expected from one of the firm's risk takers, someone such as the mortgage bond trading chief, Mike Mortara, or John Meriwether. But not Strauss, who was better known as the company stiff. Strauss himself made no secret of his concern about the risk taking at the firm, particularly in the mortgage department, which made his speech to Dunlavy seem so odd. But what Dunlavy was discovering was that Strauss, like just about everyone else at Salomon, from the CEO to the lowliest bond trader, had drunk the Salomon Kool-Aid. That Kool-Aid made taking risk second nature. It was why you worked at Salomon.

Dunlavy didn't get intimidated easily. So he just shook his head and smiled after Strauss's statement and said his guys would crank it up if that's what Strauss wanted.

When the conversation was over, Dunlavy couldn't help but think back to the Great Race. Meriwether had been willing to risk losing thousands of dollars while Dunlavy himself had wagered a measly $50 even though he'd known for a fact that he could beat an overweight, out-of-shape former high school lineman with bad knees. Maybe he wasn't cut out to work at a place like Salomon Brothers.

Dunlavy might not have been in love with risk, but he knew how to work with clients and sell them bonds, which, for the moment at least, was enough. By 1984 he was a managing director, one of the top two dozen or so senior executives. He held a series of more senior jobs in Salomon's sales and trading operation and by 1985 was working directly for the great Lew Ranieri as the sales manager for one of the hottest areas of the Wall Street money machine, one that would change the business in years to come: the Salomon Brothers mortgage bond department.

Lew Ranieri, Salomon's mortgage bond chief, wasn't so much big (he was barely five feet eight in height) as he was wide—for most of the 1980s, he weighed close to 250 pounds and reminded Dunlavy of a bowling ball. He liked to eat junk food, curse, and worry about the competition—most of all a skinny Jewish kid from southern California named Larry Fink, First Boston's star mortgage trader. Salomon had Wall Street's largest mortgage department, First Boston the second largest, and not a day went by that Ranieri didn't scream or curse out Fink—and Fink was equally paranoid about and disparaging of his rival.

On the surface, there are probably no two people more different than Ranieri and Fink. Ranieri was a college dropout from Brooklyn. Fink was a self-described "Jew from Los Angeles," the son of a shoe store owner and a college professor. Ranieri's suits were rumpled, and his tie was never tight, while Fink was almost never seen out of his suit. Ranieri gorged himself on pizza, and to this day, Fink is a serious foodie with a taste for refined Italian cuisine. But one thing they had in common was their status as outsiders; Jews and Italians were still rarities on Wall Street government bond desks, where most of the big money had been made, and that fueled the other thing they had in common: the driving ambition that would lead these two opposites to develop and grow into a market that would eventually transform Wall Street.

In the early 1980s, the concept of "securitizing" mortgages into bonds was relatively new. It involved taking relatively illiquid loans (e.g., mortgages)—stuff that couldn't be sold to the general public—pooling them into a single bond, and selling them, thus removing them from the banks' books. Think of the typical mortgage-backed security as a stew. Taken separately, each ingredient might be pretty unappetizing, but cooked together, they make something worth eating. Likewise, no investor would want to own an individual mortgage: the risk of possible default would be too great, and, if interest rates fell, the home owner would try to refinance the mortgage, thus changing the terms of the investment.

But because in a mortgage bond so many loans are packaged together, the bond represents something of value. In theory, default risk can be minimized since not all the loans will go belly-up at once; in fact, chances are most won't, so the mortgage payments of the good loans will more than cover the losses of the bad ones and generate a safe return for the investors who purchased the bond. Furthermore, because the banks could sell off

their loans as bonds, they could then make more loans, thus expanding home ownership and the credit available to consumers.

The first mortgage bond was sold in 1970 by a federal government agency called the Government National Mortgage Association, or Ginnie Mae, which was chartered by Congress to buy home loans from banks in an effort to spur more lending. The bond was known as a pass-through—the mortgages were pooled, and the loan payments were simply "passed through" to bondholders. The underwriting was a moderate success, and soon a few banks holding mortgages copied the Ginnie Mae deal.

But the market remained a backwater. The bond deals in their current form didn't really do what was ultimately needed to allow the banks to ramp up mortgage lending: remove the mortgages from the banks' balance sheets. The pass-through deals were simply a mechanism for the banks to borrow money, nothing more. The mortgages remained their obligations, and the banks still needed to hold capital against the loans.

That was all about to change.

In 1977, Lew Ranieri was called into the office of Salomon CEO John Gutfreund. Gutfreund was accompanied by a man named Robert Dall, one of the firm's senior partners and an early student of the mortgage market, and by the firm's chief economist, Henry Kaufman.

The topic of the conversation: a potentially hot new area of the bond market.

Gutfreund explained that Dall and Kaufman had done some detailed work on demographic changes and what they believed was coming: a massive expansion in housing driven by demographic shifts. The baby-boom generation needed housing and needed it soon, and Wall Street—or, to be more precise, one Wall Street firm—would be there to make the most of what was yet to come.

That's because the banks and the savings and loan industry (known as "thrifts") simply couldn't meet this demand, given their capital constraints, Gutfreund explained. But the mortgage bond market, which was still in its infancy, could. And Gutfreund wanted Salomon in on the ground floor.

With that, Gutfreund said he was reassigning Ranieri immediately to the firm's small but growing mortgage bond department.

What little Ranieri knew about the mortgage bond market, he didn't like; he traded corporate bonds, particularly those issued by utilities. There was barely any issuance of mortgage bonds and almost no trading in the simple pass-through securities that had been issued. In other words, how

was he going to make money? He was now in his prime, a thirty-three-year-old bond trader in what was then one of the hottest sectors of the market. Now he was being reassigned to the Siberia of Wall Street.

Ranieri told Gutfreund politely (that was the only way you spoke to the autocratic Salomon CEO) that he didn't know what he could add to the effort. Translation: he really wanted no part of it. "Listen, I'm not a research guy," he said, "I'm a trader, and there's nothing here I can trade. How am I going to get paid?"

But Gutfreund was adamant. "Don't worry about getting paid," he told Ranieri. "We're a partnership, and we'll find a way to make it worth your while."

There have been many explanations as to why Ranieri was chosen to become the head trader in a market that had almost no trading. One, offered in Michael Lewis's *Liar's Poker*, was that Gutfreund and Dall believed no other trader at the firm had the will to make something out of nothing and gave him carte blanche to make it happen. This was, after all, a guy who had no college degree, who'd started as a part-timer in the mail room and fought his way to trading success.

Another explanation was provided to me by Larry Fink, a mortgage trader at First Boston, who would soon become Ranieri's chief competitor and nemesis. In the 1970s and early '80s, Wall Street still had its ethnic enclaves. Fink used to laugh at all the WASPs who held key positions in Wall Street's high-paying investment banking departments. Italian Americans and Jews were outsiders in the Street's hierarchy, and the nascent market of underwriting and trading mortgage bonds was one way to break in.

"We all were smart," Fink explained, "and we understood how to use computers that helped us crunch data. But make no mistake, we were the first guys who got into the mortgage business because we weren't really wanted anywhere else."

Ranieri had considered Gutfreund his mentor, but given Salomon's brutal meritocracy he wasn't taking any chances. He rushed to find his first deal, and a few months later, Salomon packaged a number of loans into a mortgage bond for Bank of America.

This deal was different because, for the first time, Dall, with Ranieri at his side, was able to sell the rating agencies on a concept that would be known on Wall Street as "securitization." The mortgages were now moved

off the balance sheet of the bank into a pool that was "securitized," backed by so many mortgages or other collateral that the risk of default was minimal. The rating agencies agreed, and the bond won the coveted triple-A rating from the two largest rating agencies, Moody's and Standard & Poor's.

In theory, moving the loans off the balance sheets of the banks was supposed to be the beginning of the gold rush for Salomon. But the deal was a bust, as Ranieri would later say. Salomon had yet to work out all the kinks. There were tax implications that made selling mortgages to a separate entity costly for the banks. And there was still very little trading. Investors didn't really know what they were buying. Was it a bond issued by a bank or a bond issued by some amorphous entity created by underwriters to benefit their banking clients?

Other factors slowed the mortgage market's growth as well. The bane of the bond market is inflation and high interest rates, and the 1970s and early 1980s had plenty of both. (Inflation eats away at the value of the fixed income that bonds pay investors.) The Salomon mortgage department was suffering massive losses. Despite Gutfreund's promises of a grand commitment to the effort, he considered closing the department on several occasions. Ranieri, however, wasn't having it. He might have been reluctant at first, but now he had been converted into a true believer in the market's potential, and he fought with the firm's executive committee for another chance, arguing that securitization was the future of the bond markets and reminding them of the reasons they had started the department in the first place: housing was destined to explode, and the banks needed a mechanism to meet that demand. Securitization was the only solution, and Salomon had the biggest department on Wall Street.

Once Ranieri convinced his bosses to give the mortgage department another chance, he turned his attention to Washington, D.C., where he hired teams of lobbyists to change laws in order to create tax advantages for S&Ls when they sold mortgages. By the early 1980s, Ranieri's efforts began producing results as inflation disappeared, the economy began growing, and lower interest rates caused a massive rally in the bond market. All those baby boomers finally began taking out mortgages thanks to lower borrowing costs and the economic recovery, and the market that had remained dormant for so long exploded

As the market grew, the mortgage department, which had originally been Bob Dall's idea, became Ranieri's baby. It wasn't long before traders

across Wall Street were giving Ranieri credit for its creation, and that made another brash young mortgage trader seethe.

"Goddamn it, I'm getting whip chained!" Larry Fink screamed, his head rocking back as he watched his position evaporate with a sudden and unexpected change in interest rates. In 1977 Fink was just twenty-five years old. He had been trading mortgage bonds for two years and, like any young trader, was now experiencing one of many brushes with losing money. Being young and inexperienced, he had yet to develop what good gamblers and good traders call a "poker face." John Meriwether had a poker face when he lost money. So did Ranieri.

And Fink? He complained that he was being "whip chained."

The mortgage-trading desk was the smallest group in the First Boston bond department. It comprised the head of the department, a veteran trader named Thomas Kirch, and a couple of traders and bankers. The group didn't even have its own sales force; it borrowed salesmen from elsewhere in the company. But it did have Fink, whose outsized presence made up for the mortgage department's modest size. This latest Finkism occurred during a particularly rough day in the markets. Fink had lost money. How much wasn't immediately clear; it wasn't enough to get anyone fired, but it was enough to get Fink to do some serious soul-searching, and Kirch, who was his mentor, was a good place to start.

"Tom, what the fuck went wrong?" Fink asked his boss. "How could this happen?"

Kirch looked Fink in the eye and gave it to him straight: "Larry, shit like this happens all the time, and I can't tell you why. But one thing I do know is that the word is 'whip*sawed*,' not 'whip chained.' Get it straight!"

Fink was momentarily stunned and embarrassed; his boss had just humiliated him in front of his colleagues. That is, until he saw a faint smile on Kirch's face and Kirch erupted in laughter, as did the rest of the mortgage trading desk, Fink included.

Despite the laughter, there was a message that Kirch was trying to convey to the young upstart in the early years of his career: you can be really smart (which Fink was), go to the best schools (Fink had an MBA from the prestigious Anderson School of Business at UCLA), be able to add differential equations in your head (Fink was gifted with numbers),

and *still* be a lousy trader if you can't accept risk and losing as a fact of life. Every young trader learns the lesson sooner or later or washes out. One has to be prepared to lose money and not cry about it.

It wasn't long before Larry Fink developed the maturity that Kirch was calling for, and when he did, his career took off—and with perfect timing, as the mortgage bond market developed into a profit center that neither Fink nor Kirch nor any of their supervisors at First Boston would have predicted.

Part of the reason the market took off, of course, was Fink himself. Sure he was great with numbers and very good at dealing with clients. But he was even better at conceptualizing how mortgage bonds could be sliced and diced into components that could be sold to investors with varying needs and risk tolerances, which is what he began doing until he came up with an idea that took the innovation that started at Salomon Brothers in the late 1970s to a new level.

In just a few years, the mortgage market had grown amazingly complex. It hadn't been so long before that Fink and his team had come up with the idea of combining various mortgages, slicing up the cash flow into different levels of risk, and selling those levels of risk—known on Wall Street as "tranches"—to investors. The investors with the greatest risk tolerance would buy the tranche with the highest risk and the biggest yield; those with low risk tolerance would buy the "triple A" tranche, made up solely of the highest-quality mortgages, those that were least likely to default. These bonds, at least according to the rating agencies, were as safe as those issued by the U.S. Treasury. (The reality would turn out to be much different, as investors would soon find out.) To add some additional assurance, the bankers would pack the high-level tranche with so many mortgages that it would be "overcollateralized," meaning that even if a few mortgages went into default, the investor would still receive interest payments in full because the other mortgage payments would make up the difference.

If Ranieri and Salomon could take credit for selling the first mortgage-backed bond for Bank of America in 1977, Fink and his crew now could take credit for selling the latest innovation in the market. Fink was spending lots of time in the office with his analysts trying to come up with just the right structure for his new creation, while reaching out to lobbyists in Washington who had been following recent legislation that made issuing

bonds of this kind tax efficient. The new bond—known as a collateralized mortgage obligation, or CMO—was radical and revolutionary. Risk was reduced to a computer model that allowed Fink, and then the growing list of dealers who would soon copy his invention and further mold this new brand of mortgage security, to fit an investor's risk tolerance. Fink's first CMO client was Freddie Mac, the Federal Home Loan Mortgage Corporation. Freddie and its sister agency, Fannie Mae, the Federal National Mortgage Association, were "government-sponsored enterprises," or GSEs, created by Congress to encourage home ownership by buying up mortgages from banks, securitizing them, and selling the new mortgage-backed securities to investors, and they would soon become large, powerful players in the mortgage market.

The team on the receiving end of Fink's pitch included a woman named Marcia Myerberg, a finance officer at Freddie Mac, who had also been working with Lew Ranieri for years on various new structures involving mortgage debt. Ranieri had often said that Myerberg, as much as himself, was responsible for the creation of the mortgage-backed security and the burgeoning market that began to take hold in the mid-1980s. Myerberg for her part was equally effusive in crediting Ranieri for the market's growth.

But she hadn't seen anything quite like what Fink had come up with. The first CMO issue hit the market in 1983; initially they were planning a modest-sized issue of $400 million. By now Ranieri and Salomon Brothers were in the game, adding their input and variations to the final product. Freddie Mac polled potential investors, was astounded at the positive response, and decided to more than double the issue to $1 billion, tying the largest private bond issue ever (IBM had issued $1 billion in bonds a few years earlier).

Salomon and First Boston shared most of the underwriting duties on the deal, which included more bells and whistles than any other that had hit the market. More than that, the deal had set the stage for greater variations in the years to come, as well as a battle royal on Wall Street between Salomon and First Boston, and Ranieri and Fink in particular.

With the creation of the CMO, Fink became a Wall Street rock star, and he used his status to let the world know that it was he, not the great Lew Ranieri, who had created what was soon to be one of the hottest-selling products Wall Street had ever seen. Ranieri, of course, thought Fink was "full of shit," but one thing he couldn't deny was that his rival had ar-

rived. By mid-1984 Fink was named head of the First Boston mortgage department, and was rivaling Ranieri's team in size, scope, and most of all, profitability.

As Fink would later say, "We stepped in shit," which is trading desk slang for being in the right place at the right time. Though the mortgage bond departments at most firms were backwaters, the landscape was about to change. By the late 1970s, the federal government passed a law, the Employment Retirement Income Security Act, or ERISA, that imposed regulations on private pension plans, mandating that they become fully funded and thus leading them to expand the scope of their investments beyond stocks and government and corporate bonds to include the nascent market of mortgage-backed securities. At the same time, insurance companies and annuities began looking for new types of securities as well, ones that offered higher returns, or "yields," than conventional U.S. Treasury bonds.

By 1983 Federal Reserve chairman Paul Volcker had done his job; he had squeezed the economy with high interest rates that had led to a steep recession but reduced inflation to tolerable levels. Now he let interest rates fall, sparking a massive rally in the bond market. Investors "reached for yield," looking for higher interest rates than could be found on conventional Treasury bonds, and they started snapping up mortgage-backed securities, junk bonds, and anything else that offered a high return.

Most of all, "fee compression" was everywhere on Wall Street. Investment banking fees declined sharply, as did stock-trading commissions. The so-called agency business model of providing advice to corporations or individuals made less and less money thanks to a combination of greater competition and less regulation of trading fees.

All this boded well for the nascent business of packaging and trading mortgage bonds; because it was not as well understood as other markets, the fees were greater. It also pushed Wall Street in the direction of using mortgage bonds to change its business model and take on more risk. Firms began to leverage their own balance sheets, cheaply borrowing multiples of the amount of capital they had to invest in these newfangled securities, carrying them on their own books, and pocketing the interest and price accumulation.

The practice became known in trading circles as the "carry trade," and, over the next twenty-five years, the carry trade would become one of the most efficient ways Wall Street made and then lost tremendous amounts of money.

For the moment, however, Wall Street wasn't worrying too much about losing money. Interest rates were falling, and the housing market was booming. Investors who hadn't understood what a mortgage-backed security was in 1977 couldn't get enough of them just a few years later. In the weighing of risk versus return, mortgage-backed securities had an edge over other types of higher-yielding debt such as junk bonds because the big investment-rating firms such as Moody's and Standard & Poor's rated them highly. Wall Street was having it both ways: it could earn fatter fees constructing the bonds because of their complexity and then could easily trade them because of their high ratings. Indeed, many earned the coveted triple-A rating because they were securitized with a diversity of mortgages and backed up by other forms of collateral, meaning the risk of default was thought to be minimal. Indeed, the biggest risk with mortgage bonds in the early 1980s was something known as "prepayment risk." As interest rates began to fall, mortgage holders began to replace their outstanding loans with new ones at lower interest rates, thus eating into the returns of the mortgage bond holders.

The mortgage market got another boost thanks to help from the federal government. In the early 1980s, the government gave a huge tax break to savings and loans if they could sell assets such as mortgages. The move took the mortgage business to new heights. Low interest rates drove mortgage lending on a massive scale; the favorable tax treatment gave every incentive for S&Ls to get them off their balance sheets and sell them to the big Wall Street firms that securitized them. It wouldn't be the last time government intervention would cause a boom in the housing market. It's a lesson in basic economics, the sort studied by every Economics 101 student worldwide: give people incentives to issue and take on debt, and they will respond—in a big way.

By the mid-1980s the mortgage desk was no longer the place where the white-shoe firms kept their loud, fat Italian Americans or brash Jews away from the clientele. It was the place to be, and the place to be on Wall Street is where the most money is made. Young traders from top schools bypassed the chance to do investment banking deals and trade government bonds for the chance to work with mortgage-backed securities and start earning high-six-figure salaries compared to the relative chump change handed out to newly minted banking rookies. The profit margins on mortgage desks rivaled those of some of the highest-margin businesses

on Wall Street, primarily because no one understood the business but people like Ranieri, Fink, and the teams of PhDs and MBAs they hired to cobble together deals with complex formulas that weighed risk and return. Only junk bond traders such as the legendary Michael Milken, who financed leveraged buyouts using massive amounts of junk-rated debt, rivaled the mortgage desks in profit margins.

Despite the competitive tension—some of it petty (who played a bigger role in the development of the CMO), some of it not (who was more attentive to client needs)—life was good for Fink and Ranieri. First Boston and Salomon dominated the market for mortgage-backed bonds, and by the mid-1980s, both men were becoming incredibly rich. Maybe not as rich as Milken, who cut a deal that gave him a share of his firm's profits and take-home pay of $500 million for one year, but still enormously rich by 1980s Wall Street standards. Both Fink, then barely in his thirties, and Ranieri, a few years older, were earning salaries of about $3 million a year.

The more money they made, the greater their rivalry grew. With each passing day came new "innovation," or a claim of one, by either Ranieri's or Fink's troops. They bad-mouthed each other to investors and to colleagues at other firms every chance they got, becoming increasingly obsessed with the league tables, the charts that measured how many deals each underwrote. And as the competition grew, so did the amount of risk each used to squeeze out even more profits. Soon both were rolling the dice in ways that Wall Street had never before seen. Fink was just ten years out of college in 1985 and running a balance sheet that was leveraged as much as 15 to 1 and growing, meaning that for every dollar of the firm's capital he invested in the mortgage-backed market, he and his team were borrowing—and risking—at least $15 more. Ranieri's leverage was about the same, and their bets were becoming increasingly esoteric and growing swiftly in size, well into the billions of dollars.

Math geeks in their research departments pored over housing statistics, weighing the risks of defaults and prepayments, the twin evils of the mortgage bonds. The balance sheets of Salomon and First Boston were now carrying large blocks of mortgage-backed bonds on their books, borrowing what was then considered huge amounts of cash to finance holdings of the various iterations, or "derivatives," of mortgage debt that had been created in recent years, securities known as interest-only strips, or IOs, created from the interest payments of the bonds; or principal-only strips, or POs, which were just the principal portion of the bonds.

As long as the firms guessed right on interest rates, the carry trade was the most profitable bet on Wall Street, earning enormous amounts of money on the difference between the high yields of the mortgage bonds and the low interest rates paid for the borrowed money used. But a sudden change in interest rates could result in hundreds of millions of dollars in losses almost instantaneously.

At least for now, Fink and Ranieri were guessing mostly right, and the more money they made, the bigger their stature grew. Gossip around the halls of Salomon had Ranieri angling for the CEO's spot, while Fink, the skinny Jewish kid from Van Nuys who just a few years before had been screaming about being "whip chained" was now the odds-on favorite to run First Boston someday soon. In fact, Fink's ascendancy, both inside First Boston and in the mortgage market, was so swift and sudden that Ranieri demanded that his guys maintain round-the-clock surveillance on his chief nemesis's every move.

That fucking Fink!" screamed Ranieri. "If we don't keep doing this, he's going to be eating our lunch!"

Ranieri was attending a meeting along with other members of Salomon's executive committee, led by CEO John Gutfreund. At issue: whether the firm should continue risking its own capital in a relatively new, but growing and lucrative, part of the bond market known as "fixed-income derivatives," new financial products that were created or "derived" from the interest payments of another bond. The markets for derivatives were still a backwater, dominated for the most part by so-called hedge funds—pools of capital, open only to the wealthy, that risked huge sums of money by placing large bets on various markets using borrowed funds, or leverage, in order to magnify gains.

In the mid-1980s, hedge funds hadn't achieved the status they would in the next decade, so Salomon, being Salomon, saw an opening. The firm's top brass was weighing whether to expand its reach into esoteric trading and risk even farther in the nascent area of fixed-income derivatives known as the swap market. Swaps are a pretty simple concept. Start with the fact that some bonds are issued with a fixed rate of interest and some "float," meaning they rise or fall based on some index, like the London Interbank Offered Rate or the interest rates of Treasury bills. The fear of any bond investor or issuer is a sudden and remarkable change in interest rates that

scrambles investment outlooks. The CFOs of major companies that had sold billions of dollars in bonds with floating interest rates were worried that a sudden spike in rates would ramp up their interest payments. Likewise, an investor with exposure to fixed-rate debt might worry that higher rates would lead to losses since the price of a bond in the open market declines when interest rates go up—so he might want interest rates that float lower. The swaps are essentially a way to bring those parties together to reduce their risk—the issuer holding floating-rate bonds who wants fixed-rate exposure and the investor with bonds issued at fixed interest rates who wants some of his debt to float.

For several years Salomon's involvement in the swap market was pretty routine; it simply served as a middleman in these transactions, earning fees by bringing those parties together. The plan on the table—the one that made Ranieri's mouth water—was to take its role a step further. Instead of merely acting as a traffic cop by arranging the swaps, collecting a fee but not risking any of its own money, Salomon would hold some of the positions on its books—it would be betting on the directions of interest rates with house money.

There are many reasons for Wall Street's growing addiction to risk that began in the 1980s. With low interest rates, it was cheap to take risk with borrowed money and ramp up the size of trades. Financial innovations and computer technology were supposed to give traders ways to hedge their bets and weigh odds as never before (and, as the Street would discover, with varying degrees of success). There was, of course, the greed factor, which couldn't be hedged away. The bigger the risk, the more money can be made, and when the market's rolling, most traders don't take into account the inevitable bigger losses that can also result.

Then there's the issue of money—or, to be more precise, other people's money. By the mid-1980s Wall Street's private partnerships were a dying breed; one by one, the big Wall Street private partnerships became public companies that grew in size by issuing stock to public shareholders, and with that they began gambling not with the house money but with public shareholders' money.

The once-staid Wall Street business model with its modest leverage was now an anachronism, and with Salomon, now a public company since 1981, the risk taking took off. Pat Dunlavy would later recall that Salomon was in essence running a huge hedge fund under the guise of an investment bank, given the growing clout of the Meriwether arbitrage group and

the heightened risk taking of the mortgage-trading desk. The full-scale push into the swaps markets was another step in that progression.

Thus, it didn't surprise Dunlavy that Ranieri was one of the biggest proponents of the new move. At bottom, Ranieri was interested in the swap market because his biggest customers, the savings and loans that sold Salomon all the mortgages he was packaging together, were now major players in the bond market and were increasingly interested in using swaps to hedge their growing exposure. It was one thing for Salomon to act, as it had, as a mere middleman and put the swapping parties together. But if the firm were to act as a principal, offering its clients swaps as a service whenever they needed them, it would bring a mammoth new source of profit to the firm. There would be risk, of course, but why be on Wall Street if you're afraid of risk?

The meeting was held in the corporate boardroom, an ornate space with chandeliers and paintings of Salomon's partners going back to its founding. Helping explain how the swap market worked was Dunlavy, the former staircase racer, now a thirty-four-year-old senior executive who had regular contact with the firm's leaders and frequently chatted with Gutfreund about the bond market. But he had never appeared before the executive committee before. And now he was scared as he watched Gutfreund puffing away on his customary large Cuban cigar and all the firm's top executives staring at him with blank looks as if they didn't really understand—or care—what he was about to say other than the part about how the firm could make a lot of money.

Gutfreund asked no questions as Dunlavy drew on a whiteboard by hand a series of boxes and arrows demonstrating how the interest rate swap business worked and how the firm could make money from it by risking a modest amount of house money. At one point, someone asked about the amount of firm capital that would be needed; after all, more money spent on swaps would mean less capital for the other groups at Salomon Brothers, which would certainly see the new business as an intrusion on their own.

The only other question came from Henry Kaufman, a man known on Wall Street as "Dr. Doom" because during the late 1970s and early 1980s he had correctly predicted that the economy would stutter because of high inflation and low economic growth. Those days were long gone, but the name still followed him around because, unlike most of his colleagues, he

was someone who saw danger just around the corner. Kaufman asked just how much risk Salomon would be taking; Dunlavy had used the term "notional amount" of $100 million in one of his examples of an interest rate swap. The notional amount of the swap is the actual size of the bond holdings the interest rates are based on. Interest rate swaps are described in the market based on the amount of bonds or the "notional" size of the deal, but in reality this concept means very little, because counterparties merely swap their rates—they don't exchange the amount of bonds. Kaufman thought the firm would be risking the notional amount of the bond deal in addition to the interest rates, thus holding billions of dollars' worth of the bonds on its balance sheet.

Dunlavy calmly explained that at any given point in time, the risk to Salomon would be the differential between the fixed and floating rates—not the "notional amount" of the bond in question. Still, Dunlavy said, the firm would face other risks—for instance, if interest rates made a sudden shift. That could hurt its position, and the firm would be on the hook for the losses.

But Salomon would never have those "notional" dollars at risk, Dunlavy said, and Kaufman seemed appeased. Others soon chimed in that this was a unique opportunity they couldn't let slip by. Ranieri agreed. "We will need this new tool in my business if we plan to keep our dominant share in the mortgage market. You can bet Larry Fink over at First Boston is thinking about this as we speak!"

Everyone in the room knew Ranieri had a vested interest in making sure the business worked even if it didn't appear on his profit-and-loss statement—this new business would only enhance his power inside the firm. But his comments about Fink carried weight. Ranieri wasn't the only one paranoid about First Boston's growing presence in the bond market. Ranieri couldn't stand the idea of Fink's beating Salomon to the punch on anything (Fink's claim to have developed the first CMO still had him steamed), and the case he made to the executive committee was that Fink wouldn't think twice about offering swaps to the S&Ls and stealing away all of Salomon's clients.

Right before the meeting concluded, Kaufman cautioned, "We will need to monitor our credit and counterparty risk very carefully. Let's go slow with this. We should set an initial limit in terms of notional risk."

The others just listened and nodded. Dunlavy had known the commit-

tee would approve the deal once Ranieri mentioned Fink and the threat he posed to Salomon in one of the most lucrative businesses on the Street. Once a trading limit was agreed to, they unanimously approved the proposal. Gutfreund thanked the group and said gruffly, "Now go make some money!" Salomon went on to make millions of dollars trading the swaps in the next several years, and Dunlavy was promoted as his reward for helping the firm break new ground by being among the first to embrace this new type of risk.

Just like that, the foundation had been laid for the creation of a completely unregulated, opaque market that would in a few years' time grow to immense proportions, first as a tool designed to control interest rate risk and then as something totally different, a way for a firm to bet on interest rate swings and move risk taking on Wall Street to a whole new level. As the use of swaps and other derivatives grew, controlling risk became an afterthought for those using the products. The derivatives market became a huge casino, with trillions of dollars being bet by the big banks on a daily basis and each Wall Street firm looking for a trading edge over the competition.

Few people outside even knew it was happening. Junk bonds had become increasingly controversial as the 1980s rolled on, as takeover artists used junk debt to finance buyouts of some of the nation's largest corporations with high-cost debt that would have to be repaid at some point. But at least the debt was disclosed on the balance sheets of the newly acquired companies and even traded on some exchanges; the New York Stock Exchange had traded junk debt for years, with the prices clearly disclosed in newspapers. The derivatives market, however, was hidden and opaque. No central clearinghouse existed for the increasingly complex bonds derived from other bonds, or the complex maneuvers to hedge risk.

Regulators like those at the Securities and Exchange Commission and congressional committees with oversight responsibility over Wall Street had little or no idea that this market even existed and that it was growing swiftly as Wall Street embraced risk as its business model and slowly pushed traditional advisory services into the background.

No one knew, and, at least for now, no one cared about the long-term costs of embracing risk and leverage because Wall Street lives for the moment. And for the moment, risk and leverage were making Wall Street a lot of money.

At Salomon Brothers, the size of the mortgage department matched the growing size of Ranieri's waistline. He now had under his control more than 150 traders, bankers, and salesmen. Salomon's size was something Fink would ridicule—"We do more with less," he loved to point out, arguing that Ranieri ran the Spanish Armada of mortgage departments: big, slow, and easily outmaneuvered.

And Fink was developing his own counterattack. His group at First Boston was smaller than Salomon's but, over time, not by much. When Fink had started, the mortgage department had had just a handful of traders. It had borrowed salesmen and bankers from other departments. By the mid-1980s, Fink had grown the department to more than a hundred, and he continued to hire the smartest people he could find, not just to devise risk programs but also to come up with different types of mortgage bonds.

In just a few years, the mortgage market had grown amazingly complex. It hadn't been so long before that Fink and his team had come up with new ways to cobble together cash flows from various mortgages to create tranches that reflected the ever-growing needs and desires of investors, including something called the "Z" tranche, which receives interest and principal only when the other tranches are paid off (which means it's sold at a large discount) and by stripping out the interest and principal payments into so-called interest-only and principal-only bonds.

Before long, the first CMO sold by Freddie Mac seemed almost quaint and anachronistic. Computers had made the creation of new mortgage bonds from the basic model seem almost like child's play, and it didn't take Fink long to figure out that if you can securitize home loans, you can securitize car loans and credit card receivables and just about any other claim on consumers.

In 1983 Fink's team was the lead underwriter on what was then the largest bond issue ever, for the General Motors Acceptance Corporation (GMAC). The structure was similar to that of a CMO, only instead of home mortgages the GMAC bonds were created from car loans.

The deal was a blowout. Fink ended up increasing the size of the GMAC deal from $3.2 billion to $4 billion because investors couldn't wait to get their hands on the bonds, which, according to the computer models, were relatively risk free.

GMAC was a watershed deal for several reasons. Fink had proved something to Wall Street that would become both a blessing and a curse for years to come. Banks for years had had to hold capital against these loans because in times of economic hardship, people default on their credit cards or miss car payments. But through the magic of securitization, where risk could be squeezed to infinitesimal levels, these loans could be removed from the banks' balance sheets and transferred into moneymaking instruments held by sophisticated investors. Everybody was happy: the banks could make more loans and increase their fee income, the Wall Street firms and investors could make money from packaging and holding the securities, and consumers could borrow more easily (and borrow and borrow), because banks could now keep on lending.

At least that's how it all looked on paper, which for the moment appeared to be the reality of the markets and the economy. Fink was in his glory as First Boston did the honors and set the pricing of the deal, allotted how many bonds each firm would get, and walked away with a $20 million fee, while back at Salomon Brothers, Lew Ranieri was apoplectic. His archrival not only held bragging rights over the creation of the CMO but had now sold the largest bond deal in Wall Street history.

Fink didn't think it could get sweeter than that. But it did. The mortgage securities market was making Larry Fink a rich man at a pretty young age, and the money kept rolling in as the market began to expand beyond anyone's wildest dreams. The number of new mortgage deals more than doubled between 1985 and 1988, reaching nearly $1 trillion. There were many reasons for the surge—a booming economy, low interest rates that spurred a housing boom, and, of course, the Wall Street alchemy of structured finance that allowed everyone involved—most notably Fink and Ranieri—to believe that the good times would never end.

But they always do.

The battle between Ranieri and Fink was growing exponentially. It didn't generate the headlines that some others did, such as the epic RJR Nabisco takeover battle or the war waged by junk bond king Michael Milken and his firm Drexel Burnham Lambert against the entire Wall Street establishment. But inside the mortgage bond business, the Ranieri-Fink wars of the 1980s were now escalating to an almost bizarre degree.

It was the last business day of June 1985. Fink was at home with his wife

and children when he received a call that Ranieri and Salomon had allegedly priced a $250 million mortgage deal. If it had happened on any other day, Fink wouldn't care. But it hadn't. Salomon was gaming the league tables. Fink could smell it. The firm was pricing the deal on the last day of the second quarter—nearly the last minute of the quarter—which technically ended the following night, on Saturday, just to stick it to First Boston in the league tables. Wall Street executives love to brag about being at the top of the league tables—it's like a baseball team bragging about being in first place. But being at the top of the tables is more than a macho thing; clients flock to the firms that do the most business. It's like the Good Housekeeping Seal of Approval of Wall Street; if you do the most deals, you must be the best. And now that the stakes in the mortgage market were growing, being at the top of the league tables would mean much more business down the road.

In June 1985 Fink thought he had it won, at least for the first half of the year, with a seemingly comfortable lead over Salomon. It would take a near miracle—a last-minute deal—to change the ranking.

That near miracle, Fink was told, had just occurred. A trader on the mortgage desk gave him the full report: He had received a call from Ranieri's lead trader, Mike Mortara, that Salomon had just priced another $250 million offering, putting the firm comfortably in front.

Fink was in a panic when he heard the news. He had told his supervisors he had the contest locked up—the department was getting ready to celebrate with drinking and parties.

"You got to be fucking kidding me!" Fink screamed when he realized that Salomon might have edged them out. His orders were simple: call up every S&L, every bank, every client, cobble together another deal, and do it fast. The firm had just twenty-four hours to take back the lead before the quarter ended Saturday at midnight.

Well into the night, First Boston worked to put together a deal until it had its mandate: a $200 million mortgage bond deal ready to be packaged and sold upon Fink's orders. It had some buyers, and those it didn't have, it could find later. The firm would just hold the bonds in inventory and pocket the interest on its balance sheet. The deal would be messy—the firm might lose money if rates suddenly moved and investors headed for cover. But the deal would give it a comfortable lead in the league standings. It could worry about losses later.

Late Friday night, Fink was informed that the deal had been assembled. Then something struck him. The notion that Salomon had pulled

such a ridiculous stunt made him sick. It also made him sick that he'd had to go out and scrape together some poorly conceived deal that might ultimately blow up on him, just to try to save face. His gut was telling him to do the deal and take first place away from Salomon; his head was telling him not to stoop to its level and do something stupid.

In the end he listened to his head. Fink called it off and decided to wait and do the deal the right way. At the time, he said the whole episode was "too insane . . . I didn't want to carry it further."

As it turned out, Fink had made the right move, the smart move. The call to the First Boston trading desk was a joke—a hoax; Salomon had never priced a deal Friday night. Mike Mortara at Salomon had made it up because he knew it would drive Larry Fink crazy. But even in second place, he had his victory, as he told Ranieri, his boss: he had driven Larry Fink crazy, and that was almost as much fun as winning.

Even as his team fought its bitter battle with Fink, Ranieri was fighting an internal battle at Salomon Brothers against people like John Meriwether. While all of Wall Street was on a roll—Drexel Burnham Lambert, the great junk bond powerhouse, earned a remarkable $1 billion in profit in 1985—there was still squabbling over limited resources. At Salomon, Meriwether's arbitrage group was making so much money that he demanded additional turf and began taking over areas of the bond market that had been run by other departments.

One thing stood out amid all this fighting: Ranieri, Fink, and Meriwether were all remarkably similar people. They were hypercompetitive, loved to trade, and, most of all, *loved* leverage. Fink may have decided against that one last-minute deal to save the league tables because of its balance sheet risk, but he was using the balance sheet in many other ways. Official statistics aren't available, but Fink confirms that his use of leverage, his borrowing to place trades and hold increasingly risky securities on his firm's balance sheet, increased just about every year during the 1980s. Pat Dunlavy says that leverage also increased at Salomon, systematically and dramatically, as Ranieri's and Meriwether's trading profits grew.

How much? The conventional wisdom among salesmen at Salomon was that the mortgage department had leveraged itself at times more than 15 to 1, though some former executives note that the only way Meriwether's arbitrage group could have made the money it did and paid the salaries it had

(one trader eventually earned $23 million) was by using leverage that was at least twice as high. Dunlavy was astounded when he heard how much money and how much risk the firm was taking on. "I remember thinking, these guys care more about rolling the dice than they do servicing the customers, but it was obvious why they were doing it: the more they borrowed and traded, the more money they made."

Historically, Wall Street has had a love/hate relationship with leverage. Investment banks are not like traditional commercial banks, which have deposits and then borrow from those deposits to make investments such as loans to home owners. The typical investment bank is thinly capitalized, even by the changing standards of the 1980s, when firms such as Salomon, Morgan Stanley, and Bear Stearns started the trend of expanding their capital base by becoming public companies.

During good times, leverage on Wall Street soars; when the markets crash, firms typically leverage less. The 1980s were a good time to be on Wall Street, and now that most of the big investment houses (Salomon, Bear Stearns, Morgan Stanley, and Merrill Lynch) had become public companies, meaning they were risking shareholder money and not their own, as you might expect, leverage on the Street rose to levels never before seen.

With so much money being made in the bond market, some of the most risk-adverse firms on the Street saw leverage as the path to glory and started copying Salomon's and First Boston's business model of risk and leverage. In the 1980s, Bear Stearns was run by the odd couple of Wall Street: CEO Alan "Ace" Greenberg, legendary for his risk aversion, and President James Cayne, who had made his fortune betting that New York City bonds would recover after the fiscal crisis of the 1970s. They were now building a bond department to take advantage of the boom in the fixed-income markets through very high leverage, which soared to as high as 50 to 1 at some points during the mid-1980s. Even Merrill Lynch, the firm that had made its bones advising small investors on the market, had begun expanding its bond operations and growing through borrowing.

Making matters even more complicated was the fact that the people who allegedly best understood the dynamics of leverage—the risk of its turning against the borrower violently and unexpectedly to produce outsized losses equal to or exceeding the outsized gains—were the very same people who were making so much money using leverage in the first place. Why would they stop and consider the consequences when what they were doing was bringing them such outsized paychecks?