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Wall Street's troubles are yours, too

Lehman, Merrill - even Goldman - got levered up to their eyeballs during the boom. Now they, and the rest of us, are paying the price.

By Colin Bar

NEW YORK (Fortune) -- In the end, the weight of the housing collapse was too much for the weaker players in an over-leveraged U.S. financial sector to bear. Sunday evening brought ominous tidings. Lehman Brothers is likely to be liquidated after officials at the Federal Reserve and Treasury failed to line up a buyer.

But what's likely to be more distressing for investors around the globe are the reports that Lehman is far from the only U.S. financial titan that stands in need of help. Bank of America (BAC, Fortune 500) - an early favorite in the bidding for Lehman, before the Charlotte-based bank pulled out of that competition - is poised to purchase Merrill Lynch (MER, Fortune 500), the No. 3 U.S. brokerage firm.

And struggling insurer AIG (AIG, Fortune 500) is reportedly preparing to announce on Monday a deep restructuring that will result in the sale or spinoff of lucrative businesses such as International Lease Finance, the aircraft-leasing firm AIG bought a decade ago under the rein of former chief Hank Greenberg.

The sale of Merrill and demise of Lehman would reduce the number of independent firms on Wall Street to two - Goldman Sachs (GS, Fortune 500) and Morgan Stanley (MS, Fortune 500) - from five at the beginning of the year. Bear Stearns collapsed in March and was sold at a token price to JPMorgan Chase (JPM, Fortune 500).

The news that Lehman is near dissolution, and that Merrill and AIG are on the verge of big changes as well, sent the futures markets tumbling. Futures on the Dow Jones Industrial Average tumbled more than 300 points Sunday evening. Even as shares in the U.S. banking sector tumbled last week, the broader market has remained fairly resilient.

The S&P 500 rose modestly last week, in spite of the plunges in AIG, Merrill and Lehman and the nationalization of two onetime index constituents, Fannie Mae and Freddie Mac. That resiliency seems likely to fade.

The common threads among Lehman, Merrill and AIG - and at dozens of other financial firms across the nation - start with their dealing in securities tied to the U.S. mortgage market, and their rapid expansion in recent years via the use of leverage.

All three firms have taken billions of dollars of mortgage-related write downs: Lehman recently announced a nearly $4 billion third-quarter loss, while Merrill has taken tens of billions of dollars in losses on collateralized debt obligations, the risky debt Wall Street was peddling during the height of the housing boom.

Over the past three quarters, AIG has recognized some $25 billion in write downs tied to the firm's promises to guarantee the mortgage-backed debt issued by others. But if the firms made bad bets on mortgage-related securities - and all three made lots of them - something else that's striking is the degree to which the companies simply expanded their balance sheets in a bid to grab lush profits without taking precautions to make sure they could shoulder any losses that arose.

This diet will hurt

In a sense, the firms got fat during the housing bubble that sprung up in the early part of this decade, by trading debt tied to the massive expansion of consumer indebtedness in America, and they - and pretty much everyone else in this country - are now paying the price for it.

"The problem that has overcome the economy has its most recent roots in the creation of nearly $7 trillion of new residential real estate and consumer debt during the first 6 years of this decade,"Daniel Alpert, managing director at investment bank Westwood Capital in New York, wrote in March. "Simply put, this level of debt creation was unprecedented - more than doubling the amount of homeowner and consumer (credit card and auto loan debt, for the most part) debt that existing at the end of 1999."

The brokers enjoyed the fruits of the debt explosion during the housing boom, posting record profits and strong growth as investors around the globe snapped up mortgage-backed securities that promised Treasury-like safety and better yields.

But the debt Wall Street was selling turned out to be less than safe - hundreds of bond issues have been downgraded as U.S. house prices began tumbling after a years-long runup - and it soon became apparent the firms had, like the investors in their mortgage-backed bonds, failed to take adequate precautions.

The expansion of leverage at all the Wall Street firms has been startling. At the end of 2003, Lehman had $13 billion in shareholder equity - a measure of net worth - and $312 billion in assets, which meant the firm had about $24 in assets for every dollar of equity on its balance sheet.

By the end of last year, Lehman's shareholder equity had risen to $22.5 billion, a 73% increase. But assets soared to $691 billion, a 121% increase - giving it nearly $31 for every dollar of equity. Lehman's rising leverage has been much discussed as the firm's shares plunged into the teens and then into the single digits this year. But the same story has played out at Merrill, where assets doubled to $1.02 trillion in 2007 from $480 billion in 2003, even as shareholder equity only crept higher, to $32 billion from $29 billion.

And while Goldman Sachs especially, and Morgan Stanley to a lesser degree, have stood out as better-managed during the turmoil of the last year, it's not clear those firms will be able to avoid investors' wrath. Assets on Goldman's balance sheet nearly tripled over the past five years, hitting $1.12 trillion in assets at the end of 2007 against $403 billion in 2003, while shareholder equity merely doubled, to $42.8 billion from $21.6 billion.

While the turmoil in U.S. financial markets could turn frightening this week the good news - such as it is - is that no one can say the U.S. is repeating the Japan experience, in which recovery from a painful bust in the property and stock markets was deferred as the banking system failed to quickly write down bad loans and consolidate.

"Let's not make Japan's mistakes: No zombie banks, please," Westwood Capital banker Len Blum wrote in July. "When assets are overvalued, write 'em down."

Now if only recovery were that simple.