What's on the other side of this dangerous passage? In our 28-page report on the upheaval in the U.S. financial system, Fortune *looks at the populist backlash, the new king of banking, the risky business of AIG, and the ticking time bomb that's still out there: derivatives.*

BAILING OUT AMERICA

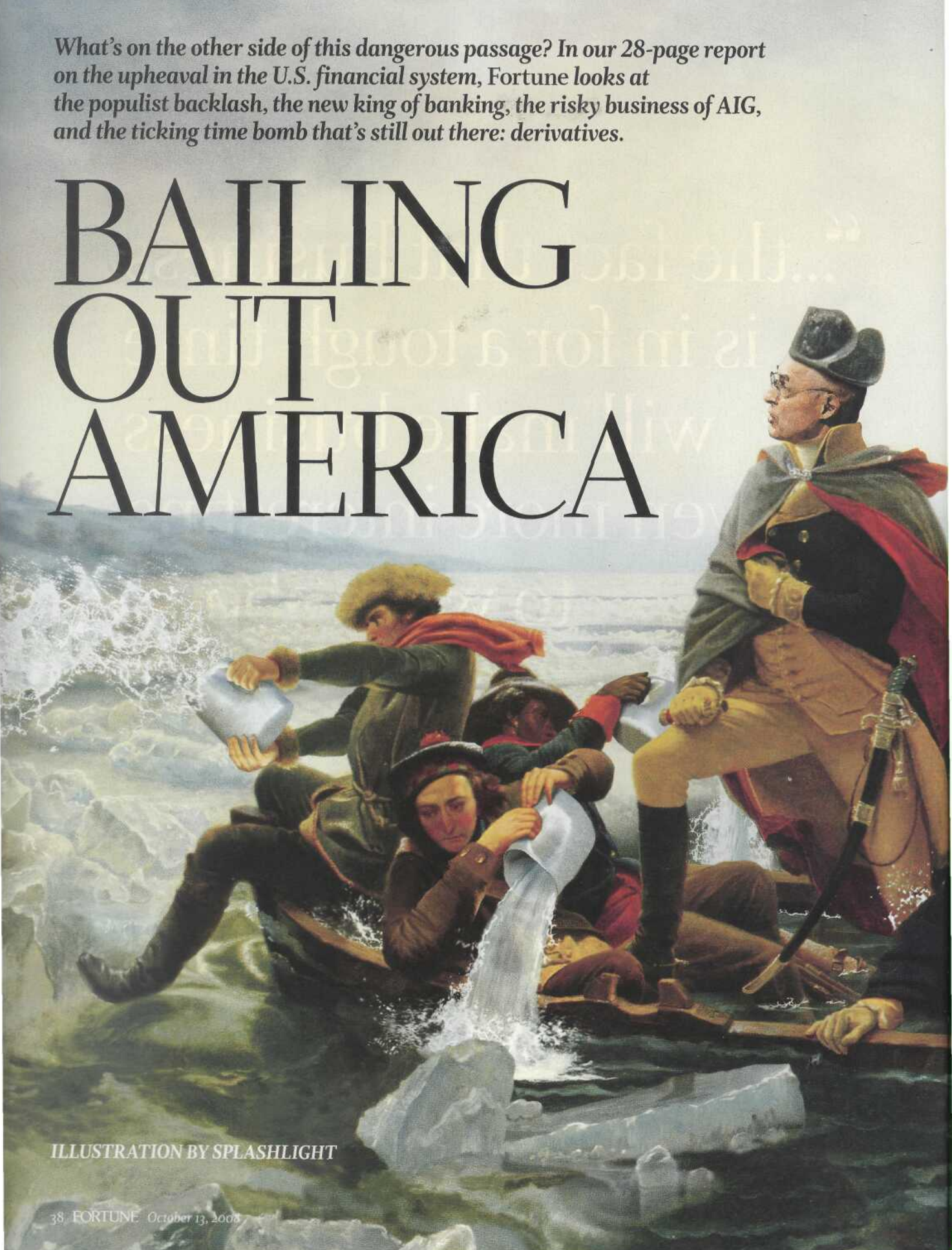


ILLUSTRATION BY SPLASHLIGHT

A populist backlash is changing America's political climate. Inflamed by the financial crisis and bailouts, a form of class warfare could haunt business leaders for years to come.

BY NINA EASTON

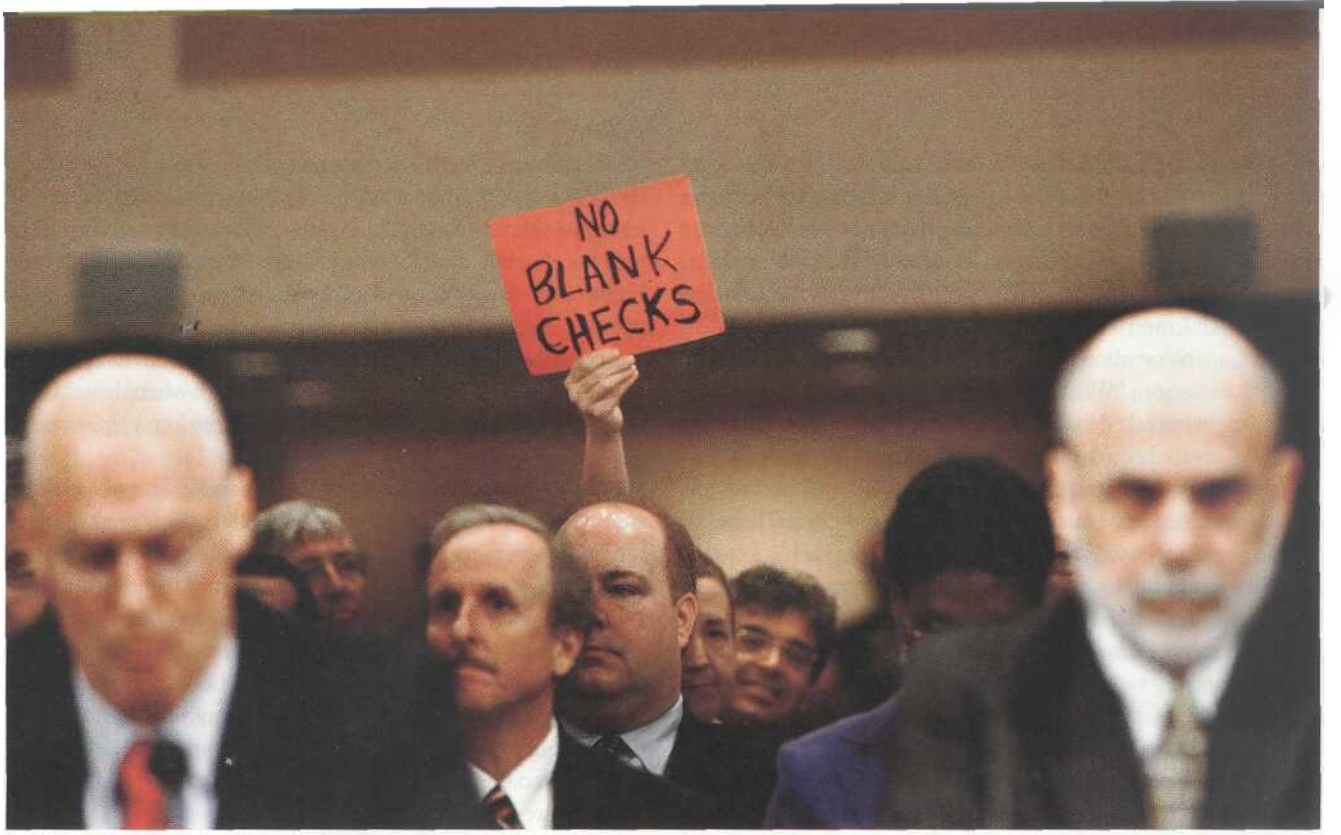
MAIN STREET TURNS AGAINST WALL STREET

IN ONE FRENZIED MONTH Treasury Secretary Henry Paulson and Federal Reserve chairman Ben Bernanke remade Wall Street. Along the way they may also have recast American politics. A month of historic government interventions shows signs of triggering a political version of climate change—unleashing a new era of class fury that could hurt U.S. companies, business leaders, and wealthy investors for years. "A potential calamity," predicts Democratic pollster Doug Schoen. "If the reactions we're seeing hold, we could have real spasmodic anger directed at businesses and corporations." And the timing will have consequences, says financier and onetime GOP presidential candidate Mitt Romney: "Unfortunately, politicians have seized on the politics of envy," he told *Fortune*, "and they are stoking it this election year like I've never seen in my lifetime."

Compared to this, Enron was a warm-up exercise. For all the public outrage over accounting scandals seven years ago, the result in Washington was limited to a financial reporting rule that most Americans have never heard of (though many in the business community still consider Sarbanes-Oxley a destructive overreaction). By contrast, the implosion of Wall Street, followed by Paulson's escalating series of multibillion-dollar rescues, has fired up populist sentiments that were already building in American politics, promising to reshape legislative battles over everything from tax and trade policies to federal regulation. Union leaders like the AFL-CIO's John Sweeney suddenly sound as if they're in the mainstream of public opinion with statements like this: "One thing is certain. No one—no politician, no investment banker, no television commentator, no economist—should be able to say again with a straight face that here in the United States we just let markets do whatever markets do and everything works out for the best."

Washington hath no fury like Middle America scorned—and there's reason to think it will only get uglier. The government's massive new financial commitments will severely tie the next President's hands in addressing middle-class concerns. "The next President will have to temper expectations a lot," says Middlebury College economist David Colander, "far beyond what either of the candidates has been willing to talk about." If that means Republican John McCain gives up on letting the upper middle class keep the Bush tax cuts, it also means that Democrats will have to stop promising ambitious spending programs. Barack Obama rightly says it would be "irresponsible" not to review his spending menu—which includes making health care universal—in light of this new fiscal reality. As for problems like Medicare and Social Security? They'll have to wait.

ON THE COOL FALL MORNING that Paulson, Bernanke, and Vice President Dick Cheney first trekked to Capitol Hill to persuade a skeptical Congress to pass an unprecedented $700 billion federal buyout of troubled bank debt, White House spokesman Tony Fratto tried valiantly to get his message out to reporters: "This is a rescue plan for the American economy," he insisted. Despite the dire warnings of financial calamity from the White House and a few high-profile business leaders, much of Middle America wasn't buying the story that their own livelihoods were linked to the fate of the rescue package. Instead, average workers read the plan as the "big guys bailing out their friends," says former House Speaker Newt



POWER GRAB? *A prime objection to the Bush administration's bailout plan was the vast power it gave the Treasury Department. Paulson, who testified with Bernanke before Congress, declared: "If it does not pass now, then heaven help us all."*

Gingrich, who commissioned a bipartisan survey on the subject. Gingrich's poll—conducted by Schoen and Republican Kellyanne Conway—found that a majority of Americans don't want Congress to use taxpayer dollars to bail out financial institutions, even if their collapse means a rocky ride for investors in the stock market.

The White House was knocked off-balance by potent blowback over the plan—not from the expected (read: liberal) quarters but from shopping-mall America. Morning talk-show hosts like Regis and Kelly shook their heads in disgust. Constituents in rural southern Illinois—a Republican district—phoned in their opposition to Congressman John Shimkus in a ratio of 200 to 1. While Senators grilled Paulson and Bernanke on one side of the Capitol, House members on the other side were offering colorful translations of their constituent views, calling the plan "socialist" and accusing Paulson of handing over "the keys to the liquor-cabinet," as Democratic Texan Lloyd Doggett put it. Within three days more than 2,000 people had logged their mostly angry opinions on CNNMoney.com.

During the unveiling of the plan, Paulson and Bernanke had exuded confidence that everyone would understand the urgency and that Congress would approve it quickly. "If it does not pass now," Paulson intoned, "then heaven help us all." They banked on public fear of a financial crash; instead, they ran into a fear from lawmakers who had to face down the folks back home angry at having to bail out Wall Street's masters of the universe. Capitol Hill brimmed with calls for limits on pay for any executive who wanted taxpayer help. Warren Buffett, with his $5 billion bet on Goldman Sachs, emerged as an example of what the government could do for taxpayers if it drove a harder bargain with the banks to collect a piece of the upside. Bush's team was already facing criticism for playing the fear card, but to get his package through, the President had to take to the airwaves to make concessions and warn his nation of doubters. "We are in the midst of a serious financial crisis. Our entire economy is in danger."

EVEN WITHOUT THE CREDIT CRISIS, the next President was going to inherit a damaged economy. "We still have very serious problems with the dollar, the trade deficit—problems that were hidden because of this increase in pretend wealth," says Colander. As President, neither Obama nor McCain would be able to count on much help from the Federal Reserve. With the dollar foundering, inflation already at 5.4%, and the government needing to sell hundreds of billions of dollars in new bonds to finance the bailout, the Fed may find it impossible to keep cutting interest rates to help stimulate the economy. "When an economy is overleveraged, it strikes me that investors are eventually going to be seeking a much higher return [from bonds and loans]," says Jared Bernstein, an Obama advisor and senior economist with the left-leaning Economics Policy Institute. America's heretofore unquestioned AAA credit rating could even come under scrutiny. "There's no God-given gift of a AAA rating," the chairman of Standard & Poor's sovereign ratings committee, John Chambers, said recently. "The U.S. has to earn it like everyone else."

When the financial crisis does pass, its political legacy will remain. Resentment toward financial profiteers is reaching a fever pitch. Leave aside for a moment the fact that homeowners living beyond their means—not just greedy Wall Streeters—contributed to

ADDITIONAL REPORTING *Jon Birger and Jia Lynn Yang*

the economic crisis. And Hank Paulson can talk all he wants about his program to help millions of struggling mortgage holders move into comfortable payment schedules. That's not what American voters were hearing as Paulson & Co. attached multibillion-dollar taxpayer pricetags to names like Bear Stearns, Fannie Mae, Freddie Mac, and AIG, even before unveiling plans to rescue banks holding bad debt, an intervention that could cost every person in the country as much as $2,300. "What we're seeing is an environment where people are being asked to shoulder enormous costs with uncertain benefits," says Schoen, who served as President Clinton's pollster.

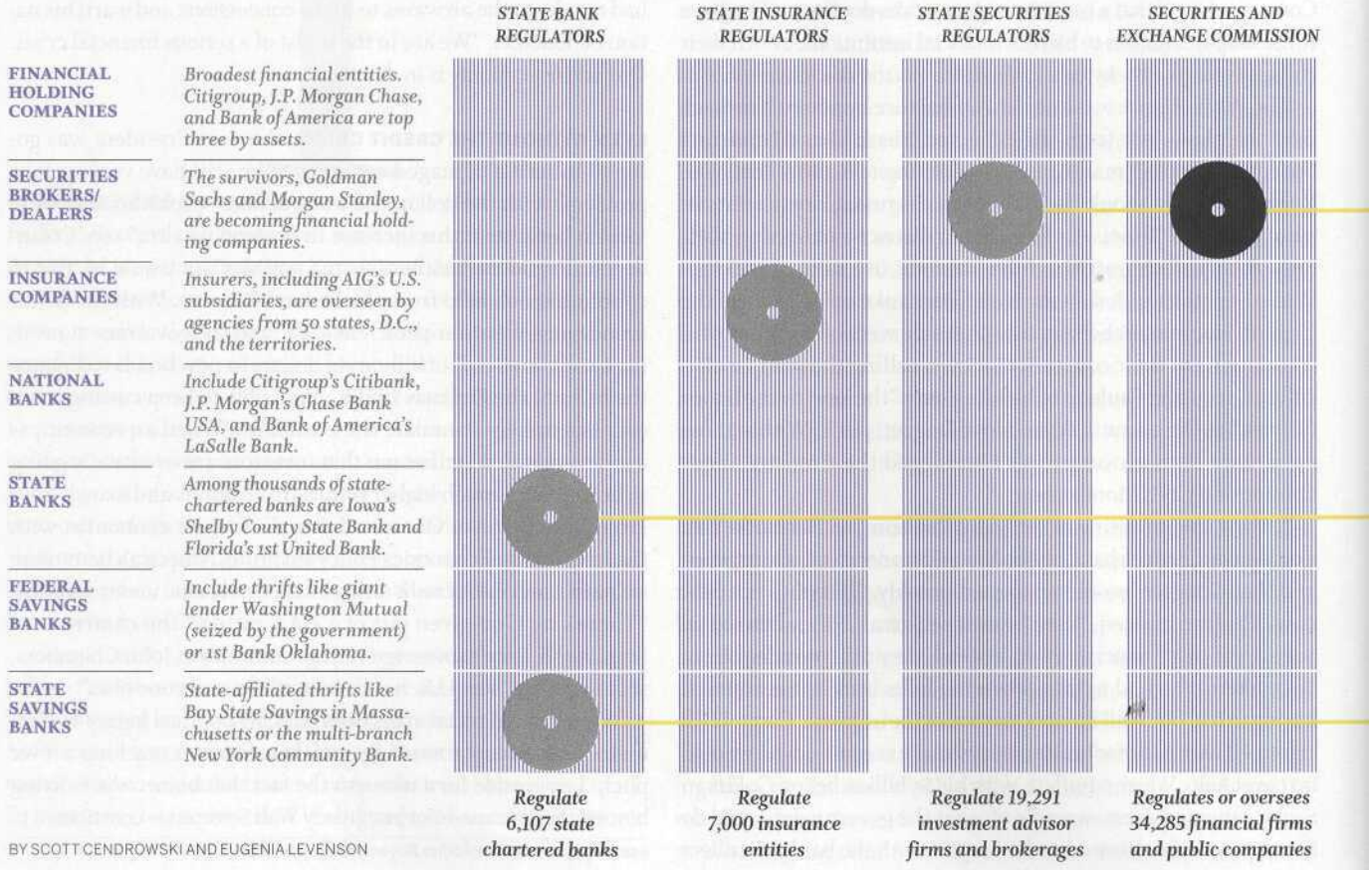
Even before this populist eruption over the Wall Street rescue, Middle America was souring on the privileged class. There has been a growing sense in the U.S. that a stagnant tide has kept the 80-foot yachts afloat while beaching the family outboard. At the start of the presidential race, the Pew Research Center found that three-quarters of Americans agreed with the statement that the "rich are getting richer while the poor are getting poorer"—up eight percentage points from five years earlier. Some 43% also agreed that America is divided into haves and have-nots, another big jump from past years.

Americans have always been conflicted when it comes to attitudes toward wealth—at once resentful yet tolerant because of the prospect of their own upward mobility. Obama's definition of a rich household—$250,000 a year—used to seem well within the sights of a middle-class family moving up the ladder, so there were limits to the effectiveness of any politician's populist rhetoric (and populist solutions). But in a decade when the American workforce has contributed a robust 20% growth in productivity, yet most middle-class households have less income than when they started, that higher income bracket starts looking more like a pipe dream.

FEEDING THE POLITICS OF ENVY is the parallel rise of a class of superrich: The top 1% of earners now collect the largest share of income since 1929, and there are more than 1,000 billionaires in the U.S. alone. Obama economic advisor Jason Furman has calculated that the rise in the income of the top 1% of earners, set against the drop in income by the bottom 80%, is the equivalent of a shift of $885 billion a year. Average CEO compensation has also caught the attention of the public and politicians. According to the Economic Research Institute, CEO compensation in 2007 increased 20.5%, to an average $18.8 million in February, while corporate revenues increased less than 3%.

WHO'S WATCHING OVER YOUR MONEY

A HOST OF REGULATORS OVERSEE THE FINANCIAL INDUSTRY, BUT THAT HASN'T STOPPED THE MARKETS FROM FALLING APART.



BY SCOTT CENDROWSKI AND EUGENIA LEVENSON

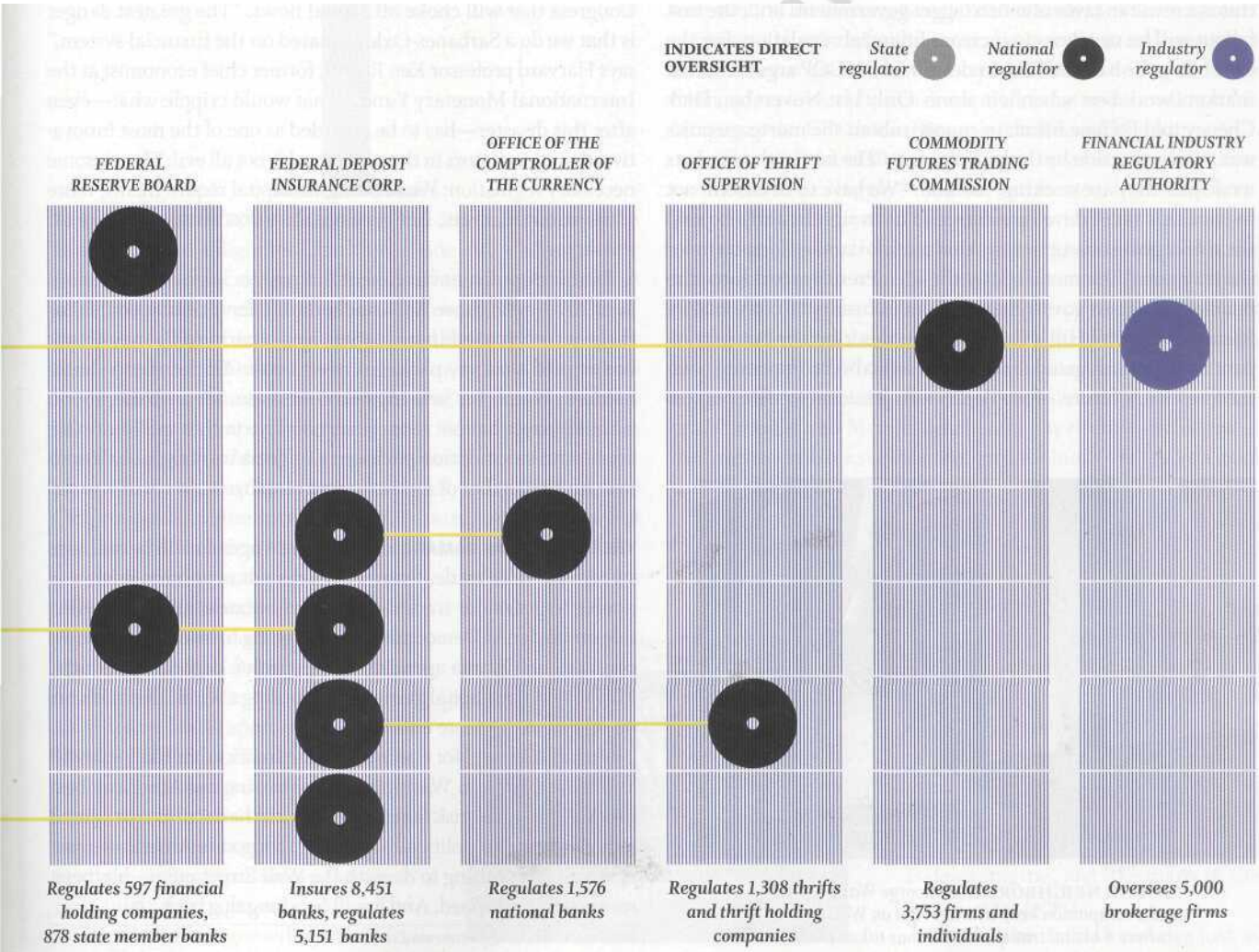
Obama used class themes from the start of his campaign, and they fit neatly into his current condemnations of "greedy CEOs and investors who are taking too much risk" (an argument that's in line with public opinion; Gingrich's survey found that 84% blame CEOs for the financial crisis). In fact, Obama's presidential bid drew from an arlready written playbook. Two years earlier Democratic strategists picked up on the rising sense of economic populism and were able to capture control of Congress with help from a platform seeking to raise the minimum wage, tax Big Oil, and rein in Greedy Pharma—though opposition to the unpopular Iraq war also contributed to Democratic gains that year.

And populism isn't limited to the Democrats. Former Arkansas Governor Mike Huckabee, a runner-up in the Republican primary, responded to Paulson's $700 billion rescue plan with this blog posting: "I'm disappointed and disgusted with my own Republican Party as I watch them attempt to strong-arm a bailout of some of America's biggest corporations by asking taxpayers to suck up the staggering results of the hubris, greed, and arrogance of those who sought to make a quick buck by throwing the dice." (Hey, Huck, tell us what you really think.)

Soak-the-rich sentiment is so infectious right now that even the Republican nominee who championed financial deregulation nine years ago is a born-again populist. McCain vows to "end the old-boys network" he says is crippling America's financial markets, repeatedly promises tougher rules on Wall Street, and immediately declared that no bailed-out executive should make a larger salary than the U.S. President ($400,000). His advisors understand that six weeks away from the election, there was no other safe political space for their candidate to occupy.

Gingrich argues that the rise in American populism is not a revolt against business alone but a revolt against all elites, including government and media elites. In his mind this is the age of the populist Andrew Jackson, not the socialist Eugene V. Debs. "We have a national establishment that talks to itself," he says, "an elite that is dramatically out of touch with the people in a way that is not sustainable." By this thinking, Wall Street veteran Paulson touched off a populist revolt not only in the substance of what he proposed, but also in the style in which he proposed it—massive Treasury spending with minimal congressional control and no judicial oversight, which critics condemned as a "power grab."

There's much evidence to support the contention that Americans are disgusted with government officials as much as they



SOURCES: NATIONAL INFORMATION CENTER; FDIC; FEDERAL RESERVE BOARD; JAMES R. BARTH; CONFERENCE OF STATE BANK SUPERVISORS; NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS; NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION; SEC; OFFICE OF THRIFT SUPERVISION; NATIONAL FUTURES ASSOCIATION; FINANCIAL INDUSTRY REGULATORY AUTHORITY. CURRENT AS OF SEPTEMBER 26, 2008

A BRIEF HISTORY OF BIG BAILOUTS

AN AEROSPACE COMPANY, AN AUTOMAKER, AND EVEN THE U.S. ITSELF HAVE HAD TO REACH FOR A HELPING HAND. BY NADIRA A. HIRA

U.S. GOVERNMENT
1894
There was no Federal Reserve when the Treasury got caught in a gold panic, so J.P. Morgan came to the rescue through a bond sale.

LOCKHEED
1971
Burned by an ill-timed move into commercial jets, Lockheed got $250 million in loan guarantees; later became Lockheed Martin.

CHRYSLER
1980
Lee Iacocca and his 134,000 workers got $1.5 billion in loan guarantees. Chrysler showed a profit in 1982 and paid off the loan the next year.

SAVINGS & LOANS
1986–95
Brought down by deregulation and risky lending, more than one thousand thrifts failed, costing taxpayers $124 billion to clean up the mess.

SWEDISH BANKS
1992
The Stockholm government spent some $12 billion to save failing banks but took an equity stake and made back much of its investment.

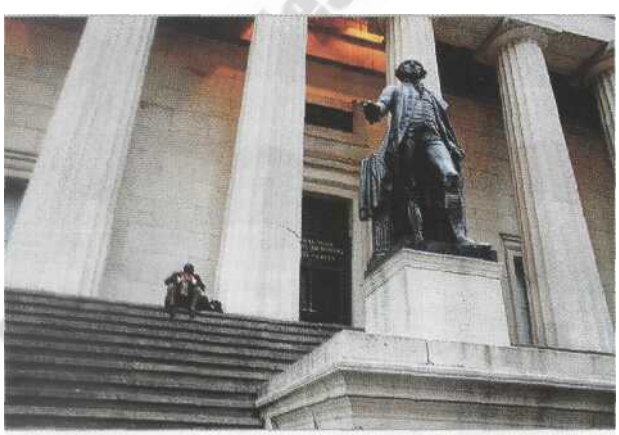
U.S. AIRLINES
2001
In the aftermath of 9/11, the U.S. stepped in with $5 billion to compensate for carriers' losses and another $10 billion in loan guarantees.

SOURCE: TOO BIG TO FAIL: POLICIES AND PRACTICES IN GOVERNMENT BAILOUTS, BENTON E. GUP, ED.

are with business leaders. And, indeed, despite the tarnished reputation of corporate America, most people still tell pollsters they credit American business with being the backbone of the economy. So the American left shouldn't be lulled into thinking this is a revolt in favor of much bigger government. Still, the first fallout will be new laws to increase financial regulation. For the time being the bailouts have undermined the GOP argument that markets work best when left alone. Only last November, Dick Cheney told *Fortune* his main concern about the mortgage crisis was an overreaction by the government. "The fact is, the markets work, and they are working," he said. "We have to be careful not to have this set of developments lead us to significantly expand the role of government in ways that may do damage long-term for the economy." Ten months later the Vice President was forced to peddle the biggest government bailout in history to conservative friends on Capitol Hill. (The result was described by one participant as an "unmitigated disaster.") It will also be impossible—in the foreseeable future—for a Republican president to sell Congress any version of private accounts to augment Social Security.

While consensus is widespread in both parties that there needs to be thicker capital buffers and more openness in the financial markets, many fear what Romney calls a draconian backlash in Congress that will choke off capital flows. "The greatest danger is that we do a Sarbanes-Oxley squared on the financial system," says Harvard professor Ken Rogoff, former chief economist at the International Monetary Fund. "That would cripple what—even after this disaster—has to be regarded as one of the most innovative, dynamic sectors in the economy. It's not all evil. There's some necessary regulation: We need higher capital requirements, more transparent markets. But goodness, we don't want to choke off the sector."

In this populist environment, fat pay packages will get more scrutiny—even those not attached to federal rescue deals. For three years House Financial Services chairman Barney Frank has argued that pay packages need better disclosure to shareholders. Watch for hearings on that issue. Meanwhile, if you want taxpayer bailout money, say goodbye to that million-dollar bonus and stock-option package; Congress wants your salary to look more like that of a government employee.



TOUGH NEIGHBORHOOD *George Washington and a companion keep a lonely vigil on Wall Street, where a brutal transformation has taken place.*

THE COLLATERAL DAMAGE to the business agenda will be far more sweeping. Take trade. Even with a decent economy, Bush was unable to get major trade deals passed because a rising populist tide emboldened Democrats. Now it's going to be even harder. By contrast, an Obama agenda of aiding union-organizing efforts, raising taxes on capital gains, and imposing a windfall-profits tax on oil is looking more enticing.

Rogoff is right: Not everyone in the financial market is "evil," and there's a risk in Washington of throwing out Americas best innovations—best risk taking even—with the detritus that caused today's crisis. But politically speaking, corporate America—most of which has nothing to do with the Wall Street mess—has been summarily dethroned. And it will be a long slog back.

EASTON, Nina. Bailing out America. **Fortune**, Amsterdan, v. 158, n. 6, p. 38-44, 13 October. 2008.