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In his 1988 annual letter to Berkshire Hathaway's shareholders, Warren Buffet wrote the following:

> *I urge you to read Charlie Munger's letter... It contains the best description I have seen of the events that produced the present savings-and-loan crisis.*

Charlie Munger is the Chairman of Berkshire subsidiary Wesco Financial and Vice-Chair of Berkshire Hathaway. Wesco does not publish historical documents on its website so I wrote to Mr. Munger in 2009 to ask him for a copy of the article (which his assistant sent me). I also asked him to consider writing about the recent financial crisis as I thought that he might have something interesting and unique to say some 20-years after his original letter.

In 2011 Berkshire Hathaway decided to buy the remaining 20% stake in Wesco that it did not already own. At the final Wesco shareholders meeting to approve the transaction held on July 21, 2011 Mr. Munger denounced bankers, accountants, Alan Greenspan and Lehman's former CEO Dick Fuld:

> *"The bubble in America was caused by some combination of megalomania, insanity and evil in, I would say, investment banking, mortgage banking,"*

The attached parody was handed out at the meeting. While Mr. Munger may not have written the article in response to my letter, I enjoyed reading it all the same. I have included on the page that follows the article my thoughts on the real-life individuals that likely inspired the "fictional" characters in his parody. Enjoy!

Michael P. McCloskey
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A PARODY DESCRIBING THE CONTRIBUTIONS OF WANTMORE, TWEAKMORE, TOTALSCUM, COUNTWRONG, AND OBLIVIOUS TO THE TRAGIC "GREAT RECESSION" IN BONEHEADIA AND THE THOUGHTS OF SOME PEOPLE RELATING TO THIS DISASTER

In the country of Boneheadia there was a man, Wantmore, who earned his income as a home mortgage loan originator. Wantmore operated conservatively. All his home loans bore interest rates of 6% or less, and he demanded of all borrowers large down payments, documented proof of adequate income and an immaculate credit-using history. Wantmore sold all his loans to life insurance companies that, before closing purchases, checked loan quality with rigor—then held all loans to maturity.

As Wantmore prospered, he eventually attracted the attention of Tweakmore, a very bold and ingenious investment banker. There was no other investment banker quite like Tweakmore, even in the United States.

Tweakmore had become the richest person in Boneheadia, driven by an insight that had come to him when, as a college student, he had visited a collection of hotels that contained gambling casinos located in a desert.

As Tweakmore saw immense amounts of cash pouring into cashiers' cages surrounded by endless sand, in business operations that did not tie up any capital in inventories, receivables, or manufacturing equipment, he realized immediately that he was looking at the best business model in the world, provided one could also eliminate commitment of any capital or expense to hotel rooms, restaurants, or facilities providing parking or entertainment.

Tweakmore also saw exactly how he could create for himself an operation that possessed all the characteristics of his ideal business. All he had to do was add to investment banking a lot of activities that were the functional equivalent of casino gambling, with the bank having the traditional "house advantage." Such casino-type activities, masked by respectable sounding labels, Tweakmore foresaw, could easily grow to dwarf all the action in ordinary casinos.

Determined to create and own his ideal business as fast as possible, Tweakmore quit college and entered investment banking.

Within twelve years, Tweakmore was the most important investment banker in Boneheadia. Tweakmore rose so rapidly because he was very successful in convincing regulators and legislators to enlarge what was permissible.

Indeed, by the time Tweakmore called on Wantmore, any investment bank in Boneheadia could invent and trade in any bets it wished, provided they were called "derivatives," designed to make counterparties feel better about total financial risks in their lives, outcomes that automatically happened. Moreover, an investment bank faced no limit on the amount of financial leverage it employed in trading or investing in derivatives or anything else. Also, Tweakmore had obtained permission to use "Mark-To-Model" accounting that enabled each bank to report in its derivative book whatever profit it desired to report. As a result, almost every investment bank claimed ever-growing profits and had ownership of assets totaling at least thirty times an ever-swelling reported net worth. And despite a vast expansion of transaction-clearance risk, no big mess had so far occurred.

Tweakmore was pleased, but not satisfied, by what he had accomplished. And he now planned to revolutionize Boneheadia's home mortgage loan business in a manner that would make Tweakmore a national hero.

In his first proposal to Wantmore, Tweakmore held much of his ingenuity in reserve. All he proposed was that Wantmore hereafter sell all his home loans to Tweakmore at a higher price than life insurers would pay. Tweakmore said that he planned to put all loans into trusts with no other assets. Each trust would be divided into five "tranches" with different priorities in use of loan payments. Four tranches would use their shares of loan payments to pay off complex new fixed-interest-bearing, freely-tradable debt instruments, called CDOs . The fifth tranch got a tiny residue in case all home loan payments were received as due. The CDOs would be sold by Tweakmore, using a highly-paid sales force, to anyone who could be induced to buy, even highly-leveraged speculators and small Scandinavian cities in the Arctic.

To Wantmore, Tweakmore's proposal at first appeared unfeasible. The planned operation seemed to resemble the operation of a meat vendor who routinely bought 1000 pounds of chuck roast, sliced it up, and then sold 950 pounds as filet mignon and the balance as dog food.

But Wantmore's doubts melted away when Tweakmore revealed how much he would pay. Under the offered terms, Wantmore would double his income, something Tweakmore could easily afford because his own income was going to be three times that of Wantmore. After Wantmore accepted Tweakmore's proposal, everything worked out exactly as Tweakmore had planned, because buyers of CDOs in aggregate paid much more than the life insurers had formerly paid.

Even so, Wantmore, as he became familiar with Tweakmore's prosperity, was soon dissatisfied with a merely doubled income. With Wantmore restive, Tweakmore now displayed the full range of his ingenuity.

What Tweakmore next proposed was that Wantmore add to his product line a new class of "subprime, pay-what-you-wish" home mortgage loans. All loans would bear interest at 7½% or more, and borrowers would not be allowed to state anything except that they wanted the money. There would be no down payments and no credit checks or the like. Also, each loan would be very user-friendly in its first three years, during which the borrower could make only tiny payments with all unpaid interest being added to principal. After three years, very onerous loan service was required, designed to pay off the greatly swollen principal, plus all interest, over the next five years.

This proposal would have seemed preposterous, even hilariously satirical, if it had been presented to Wantmore when Tweakmore had first called. But by now Wantmore had doubled his income by going along with a peculiar idea of Tweakmore's. So Wantmore's credulity was easily stretched to allow acceptance of the new loan product, which Tweakmore projected would triple Wantmore's already doubled income.

It is easy to see why Wantmore became a "true believer" in the new loan product. But why did the already super-rich, prominent, and sophisticated Tweakmore believe his revised scheme would work safely and well for him?

Well, we know the answer. As Tweakmore revealed in his prideful autobiography, his thought process was as follows:

1. There would be no significant troubles during the first three years. Under the accounting standards of Boneheadia, all its accountants would be required for a long time to reserve no loan-loss provision at all against unpaid principal and unpaid interest on the new loans. And CDOs would be valued highly in trading markets because underlying loans were booked at unreasonably high value. It wouldn't matter that homebuyers were making no down payments, had no personal liability at any time, and paid only a tiny portion of interest accrued for three years. It also wouldn't matter that that any competent inquiry would have revealed extreme past improvidence on the part of most borrowers.
2. House prices in Boneheadia would not merely rise as they had done before. Prices would rise much faster as more and more people learned they could bid to acquire homes without using any of their own money, no matter how poor were their credit-using histories.
3. All the buyers of new CDOs would have a near perfect investment experience. Ever-rising house prices would cause full payment of all mortgage debt as due. The market for the new CDOs would expand and expand as investors reliably earned much more interest than they could get elsewhere. House prices in Boneheadia would rise faster and faster as the scheme fed on itself in a runaway feedback mode.
4. True, after the first three years many over-stretched homebuyers were sure to suffer somewhat as they were forced, by threats of foreclosure, to sell their homes. This would often cost them their credit and the respect of their children, friends, and employers, but that would be the only trouble, and it would prove endurable by Tweakmore and everyone else, except the people forced out of homes.
5. The runaway feedback mode that drove up house prices would cause no significant trouble for decades, as had happened in Japan where a big bust in real estate prices occurred only after the Imperial Palace grounds in Tokyo were apparently worth more than the market value of the entire state of California.
6. The principles of economics would give the scheme a large tailwind and considerable popularity. As Tweakmore, a former student in elementary economics, knew from studying Galbraith, a large undisclosed embezzlement strongly stimulates spending because the perpetrator is much richer and the victim spends as before because he does not yet feel poorer. And what Tweakmore was creating was the functional equivalent of

a long-running undisclosed embezzlement on steroids. The perpetrators would not be the only ones to spend more, as typically occurs during ordinary embezzlements. The CDO-buying victims also would spend more as they believed they were getting richer and richer from ever-growing paper gains embodied in accrual of interest at above normal rates.

7. To be sure, the scheme looked a little like a chain-letter scheme, and such schemes were usually ill regarded by prospective users, partly because the schemes were criminal and partly because the schemes always blew up so quickly, bringing criminal troubles so soon. Tweakmore's scheme, in contrast, would, by design, be lawful and benevolent, and recognized as such, because it would create big macroeconomic stimulus as a public good.
8. And should the scheme eventually blow up after decades, like the land-price bubble in Japan, who could fairly blame Tweakmore? Nothing lasts forever. Besides, the blowup might be lost in a miasma of other blowups like those sure to come in many irresponsible countries and subdivisions of countries.

Tweakmore's revised scheme worked fantastically well for a considerable period. Naturally, there were some glitches, but Tweakmore turned each glitch into an opportunity to boost profit. For instance, when Wantmore was made nervous as hordes of scumball salesmen were drawn into his business by rich commissions paid for production of easy-to-sell "subprime" pay-what-you-wish home loans, Tweakmore responded by buying Wantmore's business. Then Tweakmore replaced Wantmore with a new CEO, Totalscum, who did not consider any business practice optimal unless it was depraved. Totalscum soon increased loan production by 400%, and his success caused Tweakmore to buy five additional loan businesses and replace their CEOs with people like Totalscum, causing profits to soar and soar, even though Tweakmore never again found anyone else whose depraved operations could produce results that matched those of Totalscum.

As Tweakmore's scheme went on, it was necessary for its continuing success that the accountants of Boneheadia never stop treating as trustworthy a lot of hugely important loan-payment promises that any sensible person would deem unreliable. However, there was almost no risk that accountants would act otherwise than as Tweakmore desired. The accountants of Boneheadia were not allowed to be sensible. They had to use by rote "rules-based" accounting standards set by a dominating man, Countwrong, who was head of Boneheadia's Accounting Standards Setting Board. And Countwrong had ordained, in effect, that all loss provisions on the new loans must remain based on the zero-loss record that had existed before Wantmore met Tweakmore. And, so long as Countwrong was in charge, no one was going to use in accounting an understanding of runaway feedback modes, instead of Countwrong's rules.

Of course, if Totalscum or Tweakmore ever started to have loan losses, he would have to start making loan-loss provisions against new loans. But there weren't any meaningful loan losses for anyone for a very long time.

Countwrong was so habit-bound as a thinker that he never recognized that his cognition was anti-social. He had always sought simplicity of process for accountants at the expense of "principles-based" rigor in thought that would better serve his country. He had been rewarded in life for his convictions, and he was now proud of his conclusions, even as they were contributing mightily to the super-catastrophe sure to come eventually from Tweakmore's scheme.

A large economic boom occurred in Boneheadia just as Tweakmore had expected. The boom made the regulators of Boneheadia feel extremely good about themselves as they passively watched the ever-enlarging operations of Tweakmore and Totalscum.

A famous regulator named Oblivious was particularly approving. He had been over-influenced in early life by classical economics. So influenced, Oblivious loved all the new derivatives, even those based on outcomes of parts of complex CDOs composed of parts of other complex CDOs. And he did not believe the government should rein in any investment banker until the banker's behavior was very much worse than Tweakmore's.

The boom initiated by Tweakmore lasted only three years. He had underestimated the boom's strength and the power of people to understand, in due course, super-sized folly. These factors had helped shorten the boom's duration. Also, Boneheadia had proved less like Japan than had been hoped.

When the boom-ending bust came, it was a doozy. Almost every investment bank had been made collapse-prone by Tweakmore's innovations before he became interested in home loans. And now, in a huge bust, most big financial institutions were sure to disappear, causing total chaos and another "Great Depression" unless there was super-massive intervention by the government, financed by printing money.

Fortunately, Boneheadia did so intervene, guided by effective leaders who somehow obtained support from politicians in both political parties. And, after this massive intervention, Boneheadia, with doubled unemployment, is enormously worse off than if the boom and bust had never happened. And its options in case of future trouble are greatly reduced because, after its money-printing spree, it is nearer to facing general distrust of its money and credit.

Boneheadia's bust is now called the "Great Recession." Yet, even so, not much has been learned by the elite in Boneheadia. Among the protagonists and too-passive types who contributed so much to the mess, only one has expressed significant contrition. To his great credit, Oblivious has recognized that he was grossly wrong.

The accounting profession remains unaware of its large contribution to public woe. And it does not recognize the cognitive defects of Countwrong, which are still believed to be virtuous qualities that reduce accountants' litigation risks and their duty to cause antagonism by opposing the wishes of some of their best-paying clients.

The professoriate in economics has barely budged toward recognition of the importance of optimized, more conservative accounting in both macroeconomics and microeconomics. And economics professors, even now, do not recognize what was so easily recognized by Tweakmore: the functional equivalent of undisclosed embezzlement can be magnified and have massive macroeconomic consequences when the victims, as well as the perpetrators, are led to believe they are getting richer under conditions that are going to last for a long time.

How about the legislators in Boneheadia? Well, most are confused by what has happened to their most powerful friends and draw no useful implications from the outcome of Canadia, a country just north of Boneheadia that had no "Great Recession" because its simple laws and regulations kept in place home loan operations much like those of Wantmore before he embraced modern finance in the state preferred by Tweakmore.

How about the regulators? Well, very few important regulators or former regulators in all Boneheadia have expressed really serious doubts about the status quo and interest in really serious re-regulation of investment banking. One of the doubters is Follyseer, a long-retired former Minister of Finance. Follyseer has argued that all the contributions of Tweakmore to investment banking should now be removed and banned, because it is now obvious that (1) augmenting casino-type activities in investment banks was never a good idea, and (2) investment banks are less likely to cause vast public damage when they are forbidden to use much financial leverage and are limited to few long-traditional activities.

Regarding accounting, no regulator now in power seems to understand, in a way that has any chance of causing effective remedial action, that the disaster triggered by Tweakmore couldn't have happened if Boneheadia's system of accounting regulation had been more "principles-based," with a different and less tradition-bound group creating accounting standards that were less easy to game.

The former regulator and life-long professor who seemed extra wise after the Great Recession was England's John Maynard Keynes, dead for more than half a century. Keynes had predicted, correctly, that "When the capital development of a country is a by-product of the operations of a casino, the job is likely to be ill-done."

Charlie Munger

Afterword: The foregoing parody is not an attempt to describe in a fair way real contributions to the "Great Recession" in the United States. Certain characters and industries, for instance, Tweakmore and investment banking, are grossly overdrawn as contributors to sin and mayhem, while other contributors are not discussed at all. The whole idea was to draw attention to certain issues in accounting, academic economics, and conceivable over-development of finance as a percentage of the entire economy, by making the characters and the story line extreme enough to be memorable.

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Postscript

Here are my thoughts on the real-life individuals involved in the events leading to the Great Recession that influenced the creation of Charlie's cast of characters that live in Bonehedia (the United States of America):

***Wantmore* –** The home mortgage loan originator. I believe that this character refers to many of the hundreds of honest mortgage originators who eventually became so enticed by the prices being paid by the Wall Street banks for mortgages and their indifference to loan quality that they eventually lowered their own lending standards and became complicit (or worse) in originating fraudulent "liar loans".

***Tweakmore* –** The very bold and ingenious investment banker. I think that this could refer to any one of a number of the Wall Street investment banks that were buying third-party originated sub-prime mortgages in the US and securitizing them. Goldman Sachs, Morgan Stanley, Bear Stearns, Lehman Brothers, Citigroup, Deutsche Bank, Bank of America, etc. were all playing the game. Several also bought mortgage origination firms in order to keep up the supply that they needed to feed their securitization machines.

***Totalscum* –** the new CEO of Wantmore who did not consider any business practice optimal unless it was depraved. I think that Charlie had Anthony Mozilo in mind when he created this character. Mr. Mozilo was the founder of Countrywide, a company that was rescued by being sold to Bank of America. BofA is still suffering today from its decision to rescue this company.

***Countwrong* –** the head of the US account standards setting board likely refers to the head of the US Financial Accounting Standards Board (FASB). Munger has long been a critic of the accounting profession for exacerbating the crisis by being complicit and often reminds them of their important role of keeping aggressive financial promoters in check.

***Oblivious* –** the famous regulator had been over-influenced in early life by classical economics, believed in the free markets and later recognized that he was grossly wrong. I have no doubt that Charlie is referring to the Maestro – Alan Greenspan. Greenspan was heavily influenced by the writings and thoughts of his friend Ayn Rand and was one of the few people involved in the Great Recession to actually come out and show some contrition when he testified before Congress. It takes a lot of guts to come out and say that your entire view of the world for the past 50 years was mistaken and for that he deserves some credit.

***Follyseer* –** the long-retired former minister of finance. This character was probably referring to Paul Volcker – the former Chairman of the US Federal Reserve from 1979 to 1987. He proposed the "Volker Rule" which attempted to once again separate the investment banking business from the commercial banking business as existed prior to the repeal of the *Glass-Steagall Act of 1933*. Encouraging less casino-like behavior by the investment banks, especially by those that have the ability to take deposits seems like common sense to me.

If you have any views that differ from mine I would love to hear from you.

Michael.