Capital Punishment: Lehman on its way to the Financial Gallows?

By Mike Whitney
Global Research, September 15, 2008
Information Clearing House 15 September 2008
Region: USA
Theme: Global Economy

Bank of America is buying Merrill Lynch for $45 billion, AIG needs an emergency $40 billion bail-out from Uncle Sam to stay afloat, and Lehman Bros is kaput. Whew! The financial world has been turned upside-down overnight and the opening bell hasn't even rung at the NYSE. It'll be a rough day of trading ahead. Paul Krugman summed up the prevailing feeling of anxiety on Wall Street like this:

"Will the U.S. financial system collapse today, or maybe over the next few days? I don't think so — but I'm nowhere near certain. You see, Lehman Brothers, a major investment bank, is apparently about to go under. And nobody knows what will happen next."

The news of Wall Street's Sunday night massacre has already send foreign stock markets into a deep swoon. Shares tumbled in Asia and dropped more than 4 per cent in Europe. The dollar is steadily losing ground to the euro and gold is on the rise. The question is not whether the Dow will fall, but "how far" and what affect that will have on increasingly fragile financial institutions.

Lehman Brothers, the 158 year old Wall Street warhorse, announced Sunday that it will file for bankruptcy after weekend rescue plans broke down without finding a buyer. Fears of credit contagion and a global recession have resurfaced and become more widespread. Lehman's failure suggests that that the other Wall Street giants will soon be following the same path to extinction. Economist Nouriel Roubini put it like this:

"All of the independent broker dealers are going to disappear. In March it was Bear Stearns. Tonight it was Lehman and Merrill Lynch. Morgan Stanley and Goldman Sachs should go find a buyer tomorrow. The business model of broker dealers is fundamentally flawed. They cannot survive."

Roubini may be right. The funny thing about capitalism is that you need capital to play. When the bank-vault is full of nothing but worthless mortgage-backed securities (MBS) and overvalued junk bonds; the whole thing goes belly-up fast. That appears to be the case with Lehman Bros, the century-old Wall Street warhorse that has joined the long procession of underwater banking establishments now ambling lemming-like towards the cliff. Lehman had a great go of it during the boom times when all it took to make oodles of money was a predictable flood of low interest credit from the Fed and a compliant ratings agency that would stamp every crappy securitized pool of mortgages with a big Triple A before hawking it to some gullible investor in Shanghai or Heidelberg. Lehman travails are not much different from anyone else in the banking fraternity. The problem is that the entire system is under-capitalized and over-leveraged. When Bear Stearns went down last year, it was levered at a ratio of 26 to 1. When Hedgie Carlyle Capital blew up, it was levered at 32 to 1. And when Fannie and Freddie were finally subsumed by the US Treasury; the two behemoths were levered at a whopping 80 to 1, which is to say that they had a paltry one dollar capital cushion for every $80 they had loaned out. That's no way to run a business. They would have continued on the same erratic path—buying up toxic mortgages and MBS from people who had no chance of ever repaying their loans–had they not been taken into federal "conservatorship", which is a fancy way of saying they were insolvent. Treasury Secretary Henry Paulson unwisely attached a 6 inch-wide money-hose from the bowels of the Treasury to Fannies front office so the two mortgage giants could continue to teeter-along at taxpayer expense regardless of the fact that the securitization business model has completely broken down and foreign investors–including China–have already started cutting back on their purchases of GSE debt. This is no laughing matter. The $700 billion US current account deficit is financed through the generosity of foreign investors who are getting increasingly jittery about sinking money into a system that looks more like casino-poker all the time. Here's a clip from China daily on Friday:

"China, which holds a fifth of its currency reserves in Fannie Mae and Freddie Mac debt, may cut the portion held in US dollars, according to China International Capital Corp (CICC), one of the nation's biggest investment banks.

"The crisis has made Chinese officials realize it's a bad idea to put all their eggs in one basket," wrote CICC Chief Economist Ha Jiming. "This will likely lead to greater diversification of foreign exchange reserve investments." China held $447.5 billion of US agency bonds as of June 2008, according to the CICC calculations using disclosures by the US Treasury. It is likely to reduce the portion of reserves in dollar assets from the current 60 percent by purchasing more non-dollar assets with new reserves, he said." (China Daily)

Naturally, foreign investors and central banks will curtail their purchases of US securities and Treasuries until there's some indication that US markets have stabilized and will be able to withstand the ferocious headwinds of the biggest housing crash in history, a frozen corporate bond market, a paralyzed banking system, and steadily waning consumer demand. But Americans still seem breezily unaware of what all this means for the country's future. They'd rather savor every new bit of gossip about some Bible beating, Grizzly-hunting prom queen who wants to lead the country back to the glory days of the 13th century than learn about the about the firestorm raging through the financial markets.

When the net foreign purchases of US financial assets begin to slow; the game is over. The Fed will be forced to raise interest rates to attract foreign capital which will put downward pressure on the economy and accelerate the housing crash. Paulson's decision to provide unlimited capital to Fannie and Freddie, will stack more and more debt atop the faltering dollar and US Treasuries. It is the equivalent of lashing the greenback to an anvil and tossing it overboard. Paulson's attempts to stave off a systemic banking crisis ensures that the federal government will undergo an unprecedented funding crisis sometime in the near future. There will be higher taxes for the battered middle class and higher interest rates for businesses and consumers. This will trigger a protracted economic slowdown and weaker growth. Credit will get tighter, banks will default, unemployment will soar and GDP will shrivel. A negative feedback loop will develop from the faltering financial system to the real economy; a vicious circle ending in massive layoffs, weakening demand, falling stock prices, and withering consumer confidence. Welcome to Soup kitchen USA.

Presently, Paulson and New York Fed chief Timothy Geithner are pressing Wall Street banking elites to pony-up enough money to buy up Lehman's devalued real estate assets. The Fed's proposal is similar to Greenspan's rescue of Long-Term Management LP (LTCM) which roiled financial markets in the late 1990s. Paulson has signaled that there be NO government bailout like Bear Stearns when the Fed bought up $29 billion in mortgage-related assets. The Fed is tapped-out having already committed half of its balance sheet–nearly $500 billion– in repos through its "auction facilities" which have recently skyrocketed to record highs of $19 billion per week for the last 3 weeks. The crisis is deepening by the day. Similarly, the Treasury has hitched its wagon to Fannie and Freddie which expands the National Debt by another $5.2 trillion and seriously undermines the "full faith and credit" of the US in the process. Keep in mind, the biggest source of American power is its access to cheap capital via the US taxpayer. Paulson has now put that source of revenue at risk by nationalizing the housing industry and burdening the taxpayer with (potentially) astronomical future obligations, even though he knows full-well that the market could drop another 15 to 20% before the end of 2010. Paulson's recklessness has doomed the country to years of struggle.

As of Sunday afternoon, no deal had been struck to buy Lehman Bros. and it looked like the bank was headed for bankruptcy. Wall Street is preparing for the worst. Many of the big players are busy working out the details on thorny derivatives contracts to avoid a sudden shock to the market. The fear is palpable and there's no way of knowing what will happen when the Asia markets open in just a few hours. It could be nothing more than a hiccup or it could be utter pandemonium ; nobody knows. Nouriel Roubini gave a particularly grim assessment of a Lehman default in his latest post on his blogsite Global EconoMonitor:

"It is now clear that we are again – as we were in mid- March at the time of the Bear Stearns collapse – an epsilon away from a generalized run on most of the shadow banking system, especially the other major independent broker dealers (Lehman, Merrill Lynch, Morgan Stanley, Goldman Sachs). If Lehman does not find a buyer over the weekend and the counterparties of Lehman withdraw their credit lines on Monday, you will have not only a collapse of Lehman but also the beginning of a run on the other independent broker dealers…Then this run would lead to a massive systemic meltdown of the financial system. That is the reason why the Fed has convened in emergency meetings the heads of all major Wall Street firms on Friday and again today to convince them not to pull the plug on Lehman and maintain their exposure to this distressed broker dealer." (Nouriel Roubini's Global EconoMonitor)

Roubini may be right if the Big Boyz fail to intervene, but will they really risk everything just to force the Treasury's hand and get Uncle Sam to pick up the tab for Lehman's bad paper? After all, the giant investment banks are inescapably trapped in a net of complex, unregulated, over-the-counter derivatives contracts which–given the right conditions—could bring every skyscraper in lower Manhattan crashing to earth in one bloody afternoon of trading on the NYSE. But, that probably won't happen. It's more likely that cooler heads will prevail as the big-hand inches closer to midnight.

A sizable portion of Lehman's $128 billion in long-term debt will probably be ring-fenced in a "bad bank" which will hold its toxic mortgage-backed assets and be financed by either the Treasury or the other Wall Street banks. The good assets can then be separated and sold off to either Bank of America or Barclays, the two prospective buyers. That way, according to Forbes, "the bad bank would be kept afloat while its assets could be unwound over a period of time in a way that wouldn't disrupt the financial system more than it already has been."

Some variation of the “Forbes solution” will probably be enacted, but, let’s be clear; this is really no solution at all. It’s just a way of buying time by rolling-over debt to avoid the ugly consequences of accounting for the massive losses. In other words, it is cheaper to keep burning up capital to prop up moribund assets than take the loss and make a genuine effort to restructure the dysfunctional system. Here’s how former Fed chief Paul Volcker summed it up just two weeks ago:

“This bright new system, this practice in the United States, this practice in the United Kingdom and elsewhere, has broken down. Growth in the economy in this decade will be the slowest of any decade since the Great Depression, right in the middle of all this financial innovation. The current financial system is dysfunctional. That is a polite way of saying it failed.”

Securitization has failed. The cuts to the Fed’s Funds rate have failed. The auction facilities–TAF, PDCF, and TSLF—have all failed. The off-balance sheets operations, the debt-pyramiding asset-inflation, the Enron-style accounting, the SIVs, the CP, MBS, CDOs, have failed. The subprimes, the piggybacks, the option-ARMs, the Alt-As have all failed. Structured finance has failed. The system doesn’t work; won’t work; can’t work. It’s built on the misguided assumption that capitalism can thrive without capital; that one dollar can be infinitely magnified by complex debt-instruments and mega-leveraging to generate real wealth and keep the wheels of finance and industry humming along. It can’t be done. The system is under-water. Economist and author Henry Liu put it like this:

“Yet this approach is preferred by those in authority, trapped in self deception about unregulated market capitalism being still fundamentally sound. They try to calm markets by asserting that the current turmoil is merely a minor liquidity bottleneck that can be handled by the central bank releasing more liquidity against the full face value of collateral of declining worth. (There are) No signs of any coherent grand strategy or plan to save the cancerous system from structural self-destruction.”

Instead, the marauding of a handful of Wall Street “innovators”–drunk with hubris and blinded by their own bizarre sense of entitlement—have thrust the financial markets to the brink of catastrophe and pushed the the broader “real” economy towards a painful retrenchment. Now everyone will pay for the greed of the few.

So, what’s next?

An article in the Financial Times spells it out, but government officials will undoubtedly deny it until after the November presidential election.

From the Financial Times:

“The debate over whether an RTC-style (Resolution Trust Corporation)vehicle is needed – perhaps just to ring-fence troubled mortgage assets – also gained traction among central bankers at the Jackson Hole symposium hosted by the Federal Reserve Bank of Kansas City in August….
The problem that an RTC vehicle could help to solve is that there are very few buyers for troubled mortgage assets, and few investors now willing to inject fresh capital into the tattered balance sheets of the banks left holding them. As a result, banks such as Lehman and Washington Mutual have struggled to sell their soured mortgage portfolios, and to broker deals for fresh capital. The takeover of Fannie and Freddie, which virtually wiped out

preferred equity holders, has also made banks' access to the preferred capital market increasingly difficult. Through a new RTC, the government could provide financial support if needed in return for a share in potential profits once the assets were liquidated. "

What the Feds are refusing to admit, is that there is already a plan in place to make the government an an active, "shareholding" partner in failing commercial banks. (There's no way the FDIC could pay for all the projected losses anyway) That will give the US Treasury the authority to provide insolvent banks with enough capital to muddle through while their impaired assets are liquidated via the RTC; a morgue for distressed mortgage-backed garbage.

How this will affect the already-anemic dollar is anyone's guess. But it won't be pretty.

It might be a good time to stock up on Krugerrands and buy a rosary.