Collapse of Lehman Brothers Anniversary

By Wayne McCaffery, Stevens Point High School

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I am moved to write a time line and explanation of the financial collapse by a talk I attended given by James B. Stewart, author of  "Eight Days: the battle to save the American financial system", *The New Yorker* magazine, September 21, 2009.  Not only that, it is the two-year anniversary of Lehman Bros collapse.

Because there are 60% of US citizens who believe that TARP [Troubled Asset Relief Program] was unnecessary I feel it is important to revisit some actual events.  You have the right to your own beliefs, but not your own FACTS or dates of events.  I have verified ALL dates and players and definitions to the best of my ability.  I am leaving nothing out intentionally.

What most of us don’t understand is that firms run very tight cash ships.  Even immensely profitable firms use short-term borrowing to smooth cash flows, to make supplies payments, or payroll.  Large and small farmers don’t carry the cash over winter needed to buy seed and fertilizer come spring, they use the credit markets for short-term purchases or sell futures.  Either way they use financial markets to do handle every day expenses.  When these credit sources freeze economic activity will stop, not slow down, but stop.  Scri]p hasn’t been seen in the US in decades. [Scrip is a certificate indicating the right of the holder to receive payment later in the form of cash, goods, or land.] Will your credit card take scrip?

This timeline could start just about anywhere.  I choose June 2007 because in early June I was with our real estate director who was having difficulties with Bear Stearns’ contracts.

 June 2007 Bear Stearns’ High-Grade Structured Credit Fund starts to fall. (sub-prime slime appears) [A subprime mortgage is a type of mortgage that is normally issued by a lending institution to borrowers with low credit ratings. As a result of the borrower's lower credit rating, a conventional mortgage is not offered because the lender views the borrower as having a larger-than-average risk of defaulting on the loan.]

July 17, 2007 Bear Stearns reports that High-Grade Structured Credit Fund has lost 90% of its value.

July 31, 2007 Bear Stearns filed Chapter 15 Bankruptcy for this and another similar fund.

February 7, 2008.  The Auction Rate Security Market (ARS) weakened. The four banks; CITI, Merrill Lynch, UBS, and Morgan Stanley, who “make the market” withdrew support for the ARS market.  Definitions:  Auction Rate Securities (ARS) are long dated bonds where the interest rate is set in the ARS on a revolving basis.  Allowing borrowers to get short-term rates on their long-term borrowing. Make a market,  action markets (ARS, NASDAQ, and others) have players who have pledged to buy or sell as needed to make an orderly market.  As prices move they will buy or sell out of their own positions or cash to make the market fluid.

February 13, 2008.  The ARS seizes [starts to fail].  80% of the bonds brought to market that day to have a new interest rate set failed, which means they fall back to their long-term rate. The Port Authority of NY and NJ had been paying 4.3% for a [collateralized] debt obligation the day before.  On Feb. 13 the rate went to 20% without trades occurring.

March 18, 2008. Bear Stearns is bought out in a forced sale at $2 per share.  Its 52-week high had been $133.20.  $2 is down 93% from end of previous week.   In an earlier financial emergency, the failure of the Long-Term Capital Management Mutual Fund (LTCM for short) in September 1998, many large banks, both US and foreign,  had pooled together to bail out the situation, most that is except Bear Stearns. (The forced buy out was I feel payback time for their non-support of the LTCM collapse.)  It was a lack of faith in Bear Stearns to be able to make good on its financial obligations that led to its demise.  “It wasn’t too big to fail, it was too interconnected to fail.”  Definition: Long term Capital Management was a mutual fund created by the Nobel Prize winners in economics, Myron Scholes and Robert Merton.  The Russian financial crisis undid them. (You might say a Black Swan.)

September 7, 2008. Freddie and Fannie needs $10 billion bailout.   This appears to be moment when the feds were ahead of the curve.  Which in this fast moving crisis is pretty amazing. Definition: Freddie Mac and Fannie Mae  are the two large home mortgage insurers that are quasi-governmental.  Freddie is Federal Home Loan Mortgage Corporation (FHLMC) created in 1970 and Fannie is  Federal National Mortgage Association founded in 1938 and chartered in 1968. By 2008, combined they backed half of the $12 trillion of US mortgages.

September 15, 2008.  Lehman Brothers files for Chapter 11 [bankruptcy protection].  Lehman’s was deeply invested in sub-prime mortgages, and had increased their leveraging from 24:1 in 2003 to 31:1 by 2007.  (Definition: *Leverage* is the ratio of dollars invested to non-borrowed dollars put up by the investor.)  A homeowner often starts out with 20% down and 80% borrowed, a leveraging of  5:1.  At this ratio housing prices would have to fall more than 20% before the home owner is upside down.  At 31:1, Lehman Bros. had investments of 31 dollars and had only $1 of their own skin in the game.  At 31:1, a bit more than a 3% drop in investments makes it upside down.

September 16, 2008. Reserve Primary Money Market breaks the buck at $**.**97.  Participants in this and other money markets start a massive withdrawal, sending commercial paper [short-term unsecured promissory notes issued by companies] markets into a frenzy. Definition:  Money Market:  a mutual fund designed to buy very short-term dated commercial paper to provide investors current short-term interest rates on their investment.  The understanding is that its daily net asset value will not fall below one dollar. Commercial paper  (repurchase agreements, where by a firm promises to repay the debt in a matter of days, typically181 days or shorter.) is short-term borrowing by firms to smooth cash flows.

The Fed immediately steps into to guarantee the $3.5 trillion in deposits in money markets.  This stops the flow out of money markets and creates a flow of money from bank deposits to money markets to get the insurance coverage. The Fed then boosted Federal Deposit Insurance Corporation (FDIC) coverage from $100,000 to $250,000.

September 16, 2008.  AIG gets an infusion from the Fed of $85 billion to meet collateral obligations.  By May 2009 the “credit line” to AIG was increased by a combination of Fed and Treasury offers to $182 billion. A down-grade in their ratings led to the need to set aside money to back up SWAPS.  [Definition: SWAPs are credit default swaps (CDS)].  It is a form of insurance to cover the default of a borrower. If I don’t think GM will make the interest payment, or return the principal at maturity of a loan, I can buy a CDS that will make those payments if a default should occur.  Unlike regular insurance, I can buy coverage for items that I don’t own or have a financial interest in.  And unlike regular insurance, if the seller of the insurance has a good credit rating, there is NO REQUIREMNT that reserves are set aside to pay for potential losses.  They are called SWAPS because if they used the name insurance, they would have needed to set aside reserves.  AIG is found to be the party insuring much of the now bankrupt Lehman Bros’ sub-prime mortgages.

By September 19, 2008 The Fed had received calls from the European Central Bank stating that if the Fed did not act quickly the largest banks in Europe would have to close.  Both GE and McDonalds contacted Washington DC to say they couldn’t meet payroll.  AND THIS IS THE POINT. Once the financial markets seized the shock waves were massive and quick.  GE needed the short-term commercial paper to smooth cash flows so as to pay their employees!!!  For the very same reason McDonalds needed the commercial paper market to pay their franchisees, who needed the payments to pay their employees!!!  How many firms, lesser-connected to Washington DC power, were in the same situation?  We will probably never know. Both administrations were very careful not to let the extent of the situation become public for fear of unleashing more waves of market failures.

Private sector borrowing fell from 15% of GDP in late 2007 to 1% in late 2008.

Contracting global trade in 2008-09 was worse than in 1929-30.

TARP was used to stabilize the situation. <http://www.newsweek.com/2010/09/19/zakaria-don-t-forget-that-the-bailouts-worked.html> another quick summary of the collapse.

It is nice that at this time we can discuss solving unemployment and not how to get markets moving again.

Wayne in WI

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