Lehman: more socialising the losses of the rich

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> Talks Continue in Effort to Rescue Lehman
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> The fate of Lehman Brothers, the beleaguered investment bank, hung in the balance on Sunday as Federal Reserve officials and the leaders of major financial institutions continued to gather in emergency meetings trying to complete a plan to rescue the stricken bank.
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> The talks took on even greater urgency on Sunday as government officials push for a deal to be completed before the markets open.

After weeks of agony, Lehman's fate appeared sealed by the end of last week, as its stock market value dropped 74% in a few days, after having lost more than 80% since the beginning of the year. That the Fed and Treasury have called an emergency meeting over the week-end ensures that things are over for the bank and it will either be bought over the week-end (with someone taking over its liabilities) or go bankrupt.

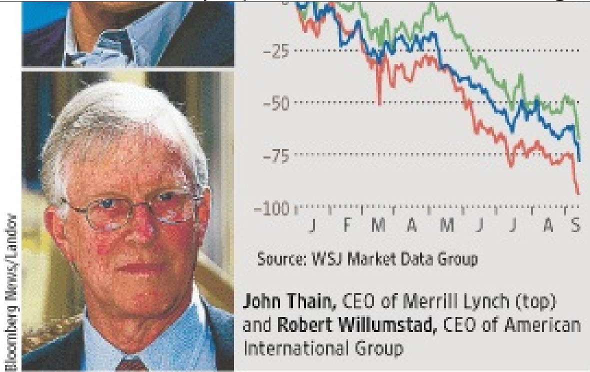
Note: This is a cross-posting of Jerome's essay from European Tribune.

And the very reason the government took action over the week-end is also the one that ensures that it will not go bankrupt: it is considered too big to fall. As the WSJ notes:

> A disorderly unwind of Lehman's derivatives trades is only one worry. Another worry is that if Lehman collapses, its distressed assets -- such as commercial real estate -- could suddenly hit Wall Street for sale, forcing prices even lower and potentially forcing other dealers to mark down once again the value of their own holdings.

With both Merrill Lynch and AIG seen as extremely weak (both lost more than 30% of their market value on Friday alone), a liquidation of Lehman could bring them, and others, down, in a collapsing house of cards.

The reason is that in a liquidation, all the liabilities become immediately due, whereas the



John Thain, CEO of Merrill Lynch (top) and Robert Willumstad, CEO of American International Group

assets need to be sold to willing buyers. So the "loss" in such a collapse is not, as it would be in normal times, the difference between the liabilities and the assets, it is the difference between the liabilities and what money can be realised fast with the assets. It's the difference between the value for you of a mobile phone, and its value for a junkie that needs to raise cash quick to get its cash.

In normal times, or for non-financial companies, such a loss could be tolerated, but in today's context, this would have a number of nasty consequences:

- other banks that deal with Lehman would suddenly lose the counterparty to these transactions: whether Lehman had committed to take a risk, or to make a payment, that commitment is suddenly in doubt, and if these transactions were a hedge for another transaction, that other transaction suddenly becomes something different. In each individual case, the risk may not be that big, but the problem is that Lehman is a big player in some markets that have become staggeringly large, like CDS (credit default swaps), which banks use to move risk arond, and which reach into tens of trillions of dollars (yes, trillions with a t). These markets are zero-sum games, but if ou suddenly remove one link in the chain, it can unravel all interlinked transactions. In a calm market, such ripples might be tolerated, but at times when banks are weakened, hoard cash and don't trust one another, it could be absolute chaos if all scramble to protect themselves in an uncoordinated way;
- even more worrisome for banks would be a firesale of Lehman assets. Banks are forced by accounting rules (which they pushed for when times were good and these rules favored them) to "mark to market", ie to value the assets they have on their books as the markets values them. For simple stocks, this is a no-brainer, but for more complex financial instruments that are not usually traded on public markets, this means valuing them by using the price comparable products fetched in recent transactions. If Lehman sold its financial assets at distressed prices, this would force many other banks to mark similar assets on their books at such prices, causing more losses to appear: these would be paper losses, to be sure, but the impact on accounts would be real and would certainly trigger regulatory requirements to raise more capital to plug the holes - at the very time when banks are struggling to shore up their balance sheets already.

In other words, a Lehman collapse could cause chaos in the markets, and bring other banks down.

So far, the solution pushed by the Treasury is not unreasonable, as the NYT describes it (link above):

> The leading proposal would divide Lehman into two entities, a “good bank” and a “bad bank.” Barclays of Britain would buy the parts of Lehman that have been performing well, while a group of 10 to 15 Wall Street companies would agree to absorb losses from the bank’s troubled assets, according to two people briefed on the proposal. Taxpayer money would not be included in such a deal, they said.
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> Under that plan, the Wall Street banks would agree to provide up to $30 billion of support to absorb the losses of the bad bank. That is roughly the same amount of money that the government agreed to commit to support JPMorgan Chase’s emergency takeover of Bear Stearns in March.

> The assets of the bad bank would be sold over time as the market for mortgage-related assets recovers and buyers emerge. If the assets appreciate, the bank consortium would share in the profits. But they would also be responsible for any losses.

Saving Lehman would avoid massive problems for Wall St's other banks, and thus it would be appropriate to get them to contribute the (much smaller) amounts that would allow for an orderly closing down of Lehman.

The problem is, of course, that each has an incentive to put up as little money as possible, as long as others put something. And none want to help the buyer of the good bits to get a good deal at their expense. But of course, no buyer has any reason to do any deal and put any money on the table unless it makes sense for it to do so.

A classic "freerider" problem, which can only be solved if there is an outside force to coordinate contributions and, if necessary, impose them. This is the function that the Treasury and the Fed can play.

But - they are themselves against the wall: if no solution is found before the markets open on Monday (and that's only a few hours away in Asia now), then there is a good chance of a total financial meltdown, something that the Treasury is desperate to avoid.

Thus it is likely that the Wall St banks are holding their own commitments to the last minute to push for public money to help make the deal. Given the precedents that have been set first with Bear Stearns in March, and only last week with Freddie Mac and Fannie Mae, it is not surprising that they expect the same to happen again.

So my bet is that we'll see another bailout of Wall Street and the financial investors it serves, with large amounts of public cash committed in a way that looks painless today (ie, no money upfront, but large liabilities into the future, likely to cost hapless taxpayers billions later--after the election).

Has this administration ever behaved otherwise? The mores and havemores have created massive problems, but they are "the base", and they cannot be let down.

They gorged in the good times, and they are letting taxpayers deal with the hangover. A sweet deal if you can get it (all you need is a few billions).

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