Lehman: Political and Personal

The man who led the firm after it collapsed says politics still reigns over policy.

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The headquarters of Lehman Brothers, Sept. 15, 2008. PHOTO: PETER FOLEY/EPA-EFE/REX/SHUTTERSTOCK

Lehman Brothers filed for bankruptcy on Sept. 15, 2008—left to twist in the wind by Treasury Secretary Hank Paulson. Ten years after, is Wall Street safe from another financial meltdown? Banks, pulling in record profits, appear to be in pretty good shape. But something seems wrong, as if the lessons of the financial crisis already have faded.

That's only an intuition, so I called someone who would know—the former CEO of Lehman Brothers. No, not Dick Fuld, one of the public faces of Wall Street's collapse. Instead, I talked last month with Bryan Marsal, of Alvarez & Marsal, who led Lehman for the three years after its bankruptcy.

I asked Mr. Marsal why Lehman was allowed to fail and what lessons were learned. He responded with two words: political and personal. What made business or economic sense wasn't considered. Mr. Marsal explained that Mr. Paulson "had no standing in the Lehman bailout decision but seemed to dominate the entire process." The Bush administration already had bailed out Bear Stearns five months earlier, and Fannie Mae and Freddie Mac the week before. Using taxpayer money to bail out perceived Wall Street fat cats had become very unpopular.

Why was Mr. Paulson channeling Ralph Kramden? The Treasury secretary, Mr. Marsal thought, "should have taken a back seat and let the pros from the Federal Reserve drive the bus." Plus, as a former Goldman Sachs CEO, "Paulson simply didn't like Dick Fuld, and he had run out of patience." It didn't help that in 1998, when Long-Term Capital Management needed bailing out, Wall Street got together and everyone kicked in, except Mr. Fuld's Lehman.

On Sept. 9, Mr. Paulson told a group of CEOs about Lehman, “There’s no government money here.” Shortly thereafter, taxpayer money went into Goldman Sachs, Morgan Stanley , Citigroup and others. It seems Fed Chairman Ben Bernanke grabbed control of the bus from Mr. Paulson after the almost instant contagion and carnage from the Lehman bankruptcy. Withholding a bailout was a mistake. A subsidized merger or an orderly bankruptcy would have made more sense.

Why is this so important? Today there is nothing stopping the political and the personal from trumping rational economic decision-making in the next crisis. Sure, there’s Dodd-Frank, which passed in 2010 after congressional blathering about arresting bankers. But Mr. Marsal suggested the law makes Wall Street less safe: “The Federal Reserve demonstrated that it had the power to stem a liquidity crisis before the Lehman fall, by virtue of the post-Lehman actions.” But it was implicit, unstated. Now, it’s explicit. Read Section 214 of Dodd-Frank: Prohibition on Taxpayer Funding. In a crisis, the Fed and Treasury could ask Congress for powers and probably get them, but that brings them back to the political and personal again.

Many of Lehman’s creditors couldn’t get paid back for years because much of the company’s capital was domiciled in Europe. Unable to get their Lehman money, funds and individual investors sold anything liquid to have working capital and pay off debt. That’s why the stock market sold off so hard in early 2009. Mr. Marsal explained, “In the U.S., a liquidation has its primary objective of recovery maximization to the creditors.” Lehman would prepay as much as 90% of claims and finish returning all assets in 3½ years.

In the U.K., on the other hand, the “primary objective is the minimization of liability to its receiver, encouraging decisions at glacier speed increasing the cost to the creditors.” Ten years later in Europe, PwC is “still rolling along,” presumably still collecting fees. This lesson of liquidity is rarely discussed, but it may have been the most important postbankruptcy menace.

Has anything changed? After dealing with Lehman’s unwinding, Mr. Marsal had hoped for a cohesive regulatory framework from Washington. Instead the bureaucracy won. Still active and influential are the Federal Reserve, the Federal Deposit Insurance Corp., the Office of the Comptroller of the Currency, the Commodity Futures Trading Commission—plus the Treasury, which should stay out of bailouts, and a growing bureaucracy created by the Dodd-Frank Act. No entity is in charge, so everyone is in charge. Politics still reigns over sound policy.

There is more concentration in banks today than pre-Lehman. They’re better capitalized with better reserves, but it’s still fractional reserve banking. And the shadow banking business that got drenched in derivatives may be larger today than it was before the crisis. Leveraged loans are rampant. That doesn’t point to stability.

In downturns, equity hurts but debt kills. Like an electrode-implanted rat that can’t stop pushing a pleasure lever, banks will lend until they implode. A decade ago, the Fed failed as the lender of last resort. It’s still failing at preventing the next crisis.

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