The Lehman legacy

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On September 15, Catherine Naud checked her Washington Mutual bank account before she began a 10-day road trip across Utah, Arizona and several other states. On her return to New York, Ms Naud, a scientist at Columbia University, logged on to her bank's website. "I got a message that I was now a JPMorgan customer, that Washington Mutual no longer existed," she says. "I was shocked."

It is a reaction many other policymakers and investors would now echo - not just in relation to last month's demise of WaMu, the largest US savings and loans association, but also to the wider financial crisis that is convulsing the global economy. After all, when the credit turmoil began just over a year ago, many bankers and policymakers maintained it would be over in a matter of months, since the losses could be easily "contained".

While this view proved overoptimis-tic, a few months ago it did seem as if the worst of the financial panic might be ebbing away. More specifically, when Bear Stearns, a large US stockbroker, imploded back in March, some thought that might be the biggest upheaval the crisis would bring - not least because the markets rallied after Bear was acquired by JPMorgan Chase.

Instead, the sense of panic has escalated in the past few weeks, creating a fresh wave of bank failures. Consequently, as global leaders scramble to introduce emergency measures -including the prospect of governments taking direct stakes in banks - the question many non-bankers such as Ms Naud might ask is: why has all this become necessary? What has caused the resurgence in financial panic, in a manner that has apparently left global leaders so scared?

The catalyst arguably came four weeks ago today, just as Ms Naud was setting off on her holiday. In the early hours of September 15, Lehman Brothers, the 158-year-old Wall Street institution, filed for bankruptcy. Despite round-the-clock talks with banks and investors over the preceding weekend, US financial authorities decided not to step in to prevent the collapse. "I never once considered it appropriate to put taxpayer money on the line in resolving Lehman Brothers," Hank Paulson, Treasury secretary, said the day after Lehman's demise.

Six months earlier, the Federal Reserve and the Treasury had stepped in to prevent the rival Bear Stearns from filing for bankruptcy. After that, officials came to take the view that dealers and investors had become well aware Wall Street banks were no safe bet. These hopes were misplaced. The Lehman bankruptcy set in train a series of damaging events in an unexpected quarter: the $3,500bn (£2,055bn, €2,590bn) US money market fund industry, used by banks and companies across the world for their short-term financing needs.

The day after the bankruptcy, the $62bn Reserve Primary Fund, the country's oldest money market fund, posted this sombre statement on its website: "The value of the debt securities issued by Lehman Brothers Holdings (face value $785m) and held by the Primary Fund has been valued at zero effective as of 4pm New York time today."

This pushed the value of the assets in the fund to below their $1 per share face value. In other words, the fund had "broken the buck" - an event greatly feared by regulators and fund managers since the start of the credit crisis more than a year before. "Lehman's bankruptcy was so significant because it led a fund to break the buck," says Deborah Cunningham, chief investment officer at Federated Investors, one of the biggest money market investors. "Lehman would probably not have had more of an effect on markets than any other bank collapse if it had not been for this tag-on effect in the money markets."

Money market funds' popularity rested on their reputation for being almost as secure as bank deposits. Marketers of the funds had long emphasised that only one small fund had ever "broken the buck", and that was 14 years before. The fear was that once one fund showed that investors could lose their principal, the damage to the industry would be severe.

These concerns proved well founded. As word of the Reserve Fund's predicament spread, investors fled. By that weekend, more than $200bn had been pulled from money market funds, by both retail and institutional investors. When other short-term funds, such as prime funds, are included, the amount that was taken out of short-term investments quickly reached $400bn.

That shift brought the funds under heavy pressure to sell into an illiquid market, simply to ensure they had enough cash to pay investors withdrawing their money. For banks, heavily reliant on these investors for their funding needs, it created a spiral of liquidity crises. "It was the straw that broke the camel's back," says Joe Lynagh, a portfolio manager at T. Rowe Price, an investment company.

To assure retail investors, the Fed quickly lined up a liquidity facility for money market funds, allowing them to sell short-term debt backed by assets. However, that was not enough. Last week, the Fed started buying commercial paper in an attempt to break the impasse, but it was too late for some banks faced with billions of dollars of short-term funding needs and nowhere to raise the money.

"The impact of the investor pullback is borne most heavily by banks that are predominantly reliant on wholesale funding, a group that includes many European banks," says Alex Roever, analyst at JPMorgan. "This investor pullback from the secured dollar bank commercial paper market is a contributing factor in the recent wave of liquidity issues at European banks."

Should this have been foreseen? There were plenty of market indicators suggesting Lehman could default -mainly the soaring cost of insuring in the credit derivatives market against that eventuality. Yet most investors holding cash bonds did not appear to be mentally or practically prepared for a default.

"Prior to Lehman, there was an almost unshakable faith that the senior creditors and counterparties of large, systemically important financial institutions would not face the risk of outright default," notes Neil McLeish, analyst at Morgan Stanley. "This confidence was built up ever since the failure of Continental Illinois (at the time the seventh largest US bank) in 1984, a failure in which bondholders were [fully paid out]."

For months, regulators including the Bank of England as well as the Fed had been putting pressure on banks to prepare for a default by a big market participant. The risk of a bank collapsing under the weight of overvalued and illiquid mortgage backed securities and a funding crisis had been demonstrated by the fate of Bear Stearns.

With Wall Street's big broker-dealers involved in millions of derivatives trades, which feature in contracts from basic hedges on oil prices to complex structured debt securities, regulators were worried that the unravelling of such trades could be the downfall of the financial system.
Yet it now seems that, with all the emphasis on limiting the fallout on markets such as derivatives, a more straightforward consequence of a bankruptcy was overlooked: the pain it imposes on creditors.

First, Lehman hurt its bondholders. Lehman was a very large borrower, with around $130bn in debt outstanding. The expected losses on these bonds spiralled swiftly. In early September, they were trading at 95 cents on the dollar but by the Monday after bankruptcy had fallen to around 40 cents -and last week to 10 cents. Its short-term debt - as the Primary Reserve Fund found was essentially worthless.

Second, investors such as hedge funds, which had money or assets held at Lehman, were hurt, too. Hedge funds that were using Lehman as a prime broker found that their collateral was frozen as its complicated bankruptcy process got under way - which in turn effectively left many of these funds frozen as well.

"A lot of people did not understand the implications of Lehman's default," says a chief executive of a large hedge fund. "Whether it is a misimpression or bad assumptions, the fact

is, as a hedge fund with balances at Lehman, you lost access to those balances when it went bankrupt. Hedge funds have joined the list of unsecured creditors and many were not prepared for this."

To make matters worse, the fragmented legal infrastructure in Europe, combined with differences in bankruptcy laws with the US, left even expert lawyers uncertain about exactly how a bankruptcy might proceed. Many experts predict it could take years to unwind Lehman, the world's biggest ever corporate bankruptcy case.

Hedge funds, like money market funds, have therefore shied away from an exposure to bank debt. "People are rightly a lot more conservative in their assumptions about credit risk," says Ms Cunningham.

"After the failure of Lehman Brothers... institutional investors have said that they would prefer to stay home," says Bill Gross of Pimco, the bond fund manager. "Instead of risking their money [it] goes into that figurative mattress."

Getting the money out of the mattress and back as a source of financing for banks is one of the biggest tasks now facing politicians. "With financial markets worldwide facing growing turmoil, internationally coherent and decisive policy measures will be required to restore confidence in the global financial system," the International Monetary Fund said last week, warning that a failure to do so would be "costly for the real economy".

Policymakers will today be watching the markets closely in the hope that the weekend meetings on both sides of the Atlantic aimed at tackling the crisis will start to restore confidence in the global financial system.

But with so many professional investors having run for the exits, the key now is also to ensure people like Ms Naud do not become so worried that they take their money out of their newly renamed banks and place it under a rather more literal mattress.

Fonte: Financial Times, London, October 13 2008, Primeiro Caderno, p. 11.