Triweekly Series

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LINDNER INSIGHTS

Did We Learn Anything from Lehman? (The Crisis Ten Years Later)

"In downturns, equity hurts but debt kills."

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"Big enough to deliver, small enough to care"

by Chris Briggs, CFP®

Did We Learn Anything from Lehman? (The Crisis Ten Years Later)

Do you remember what you were doing September 7, 2008? I do. I was leaving church on my way to play golf when a buddy of mine called to say Hank Paulson just announced that the Treasury was "putting Freddie and Fannie in time out." I thought my friend was joking, but he wasn't. That morning, the Treasury Secretary announced that after close review of the financial condition of the two Government Sponsored Enterprises (GSEs), they had no choice but to put them into receivership. Assuring the country that by this action they could restore calm to the country's mortgage market. The quote that sticks out in my mind is, "Nothing about our actions today in any way reflects a changed view of the housing correction or of the strength of other U.S. financial institutions." [1] By this point in 2008, it was too late, the damage was done.

Home prices fueled by cheap adjustable rate mortgages and low underwriting standards had peaked in late 2006 and early 2007.[2] Stock prices had also hit their pre-crisis highs in the fall of 2007. An interesting problem began to occur. Political pressure had lowered down payment and underwriting standards to encourage a broader participation in the "American Dream". Leaving no room for natural fluctuation of home values, any down turn in value would leave a borrower owing more than the home could be sold for. Many of the home purchases made in 2002-2006 were made with little or no money down and used adjustable rate mortgages, whose payments rise with rates. The Fed had been raising rates steadily from June 2004 through June 2006.[3] Rising rates pushed up the payments on the adjustable rate loans and made new purchases less affordable, resulting in falling home prices. Home equity quickly evaporated as the result of falling prices. Rising payments on an asset declining in value is a recipe for loan default, or what became known as the "key toss", as upside down homeowners walked away from their mortgages. Bear Stearns, one of the largest players in the mortgage market, required rescuing in March of 2008 as their capital came into question.

The Federal reserve convened its first "emergency weekend meeting" in 30 years on March 17th, 2008 agreeing to back Bear Stearns' bad loans (about $10 trillion worth) and brokering the firm's purchase by J.P. Morgan. On March 19th, the regulators in charge allowed Fannie Mae and Freddie Mac to assume another $200 billion of subprime mortgage debt. This approval allowed the two GSEs to buy these low-quality loans from banks to repackage into agency backed bonds, making Freddie and Fannie liable for all those people doing the "key toss"! Not to be left out, the Federal Housing Finance Board authorized the regional Federal Home Loan Banks to take in an additional $100 billion of low quality loans, also guaranteed by Freddie and Fannie. On the same day, the Fed lowered interest rates by .75% (a common

[1] https://money.cnn.com/2008/09/07/news/economy/paulsonstatement/index.htm
[2] https://www.thebalance.com/2008-financial-crisis-timeline-3305540
[3] http://www.fedprimerate.com/fedfundsrate/federal_funds_rate_history.htm

Fed action is .25%), to 2.25%, fueling bond speculators. The result was the destabilization of one of the core pillars of housing finance in the United States.[4]

On July 12, 2008, IndyMac Bank failed, causing depositors to line up at their locations demanding the money held on deposit. Many people experienced hardship, since the FDIC only insured amounts up to $100,000.

Trying to calm the public, Secretary Polson hit the Sunday talk show circuit on July 23rd. He explained the need for a bailout of the nation's two mortgage giants. Together the two either held or guaranteed more than half of the nation's mortgages. Freddie and Fannie both being publically traded saw huge losses in share value, making it virtually impossible for banks around the country to raise capital. Over the next several weeks, Congress and the Treasury tried several small bailout programs, but none worked to stop the panic.[5]

After the Government takeover of Freddie and Fannie on September 7th, 2008, I remember thinking how could this get any worse. The next several weeks felt like Armageddon.

Believing the Treasury had done enough by rescuing Bear, Fannie and Freddie, Hank Paulson felt it was not necessary or proper for the government to take on all the risks resulting from the poor decision making by aggressive bankers. Lehman Brothers was clearly in trouble. When Paulson refused to provide protection against losses for potential buyers, Bank of America and Barclay's, the talks to save the 164 year old investment bank ended abruptly.[6] The result was the failure of Lehman Brothers, which filed for bankruptcy on September 15th, 2008.

Lehman's bankruptcy set off a chain of unfortunate events…….

- September 16th, 2008 – The Fed took over AIG which was the insurer for trillions of dollars of mortgages around the world.
- September 17th, 2008 – Fearing Lehman's bankruptcy and what occurred with AIG, investors redeemed money market funds at a record pace. The result was a freeze in the short-term funding businesses use to fund their day-to-day operations and to meet payroll.
- September 18th, 2008 – The Fed and Treasury asked Congress to approve a $700 billion bailout package to buy up all the troubled loans held by banks and hedge funds. Paulson said, "If this doesn't pass, heaven help us all."
- September 19th, 2008 – The Fed announced it would insure money market accounts, freeing up the cash businesses needed to meet payroll and other short-term obligations.
- September 22nd 2008 – Goldman Sachs and Morgan Stanley applied to change their charters from investment banks to commercial banks so the Fed would protect them.
- September 26th, 2008 – Washington Mutual Bank went bankrupt when panicked depositors withdrew almost all their funds, requiring the FDIC to take over what was left and sell it.
- September 29th, 2008 – The stock market went into free-fall when Congress refused to pass the bailout bill.

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[4] https://www.thebalance.com/2008-financial-crisis-timeline-3305540
[5] https://www.thebalance.com/2008-financial-crisis-timeline-3305540
[6] https://www.investopedia.com/articles/economics/09/lehman-brothers-collapse.asp

- October 3rd, 2008 – Congress passes the Troubled Asset Relief Program (TARP).
- October 6th, 2008 – Markets crashed again as mistrust grows between world counterparties.
- October 14th, 2008 – The governments from around the world acted together to shore up markets. Governments from all over the European Union, Japan and the United States participated.
- Throughout the rest of October and into late November, the Treasury and Fed acted together to un freeze the trillion-dollar market for student, auto and consumer debt.
- November 21st, 2008 – The government gave an additional three months unemployment benefits to those who lost work as the result of the crisis.
- December 16th, 2008 – The Fed lowered interest rates to 0%.
- Late December – The Treasury injected capital into a number of banks through the purchase of preferred stock.
- January of 2009 – GM and Chrysler were bailed out, saving an estimated 3 million jobs. [7]

The stock market finally bottomed in March of 2009, paving the way for the 9+ year expansion and bull market we are currently experiencing.

I think there are several lessons worth learning for what happened.

1) Not all bubbles are caused by excessive valuations. The bubble that resulted in the financial crisis was not caused by overvalued stocks. This was a credit bubble. Debt becomes hard or impossible to service when rates rise dramatically.
2) Liquidity disappears in times of crisis. Securities that are easy to trade in good times can be the opposite in bad times. During the crisis this was the case with corporate bonds, once easy to trade, then not. Watch out for ETFs. Who knows how some ETFs may trade during extreme stress if there is no liquidity in the underlying securities.
3) Long periods of calm can lead to chaos. Long periods of growth can lead to complacency. Read Hyman Minsky. His theory of "Ponzi debt" is fascinating.
4) Financial innovations often cause problems. Innovations that allow a way around regulations or access to markets by unsophisticated investors often end poorly. Today's credit funds or the huge volume of non-bank lending designed to avoid regulatory hurdles may prove to be more of a problem than a solution.
5) This time is different……This time is never different!

"J.K. Galbraith summed it up beautifully in 1975 in the foreword to his sweeping *The Great Crash 1929,* 'As a protection against financial illusion or insanity, memory is far better than law. When the memory of the 1929 disaster failed, law and regulation no longer sufficed.'" [8]

It is our job as advisors to be our client's memory bank, providing perspective and a voice of reason. At Lindner Capital Advisors, we remain prepared to help you with this process.

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[7] https://www.thebalance.com/2008-financial-crisis-timeline-3305540
[8] https://www.wsj.com/articles/lehmans-lessons-10-years-later-1536255748?mod=article_inline

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Ask your Relationship Manager for a copy of "The Educated Investor" written by Robert Lindner.

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