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It's Uncle Sam's investment club

U.S. government has become irreversibly involved in many businesses' affairs

SUMMING IT UP

William Rutherford

One day in the not-too-distant past, seemingly eons ago, top executives of Lehman Brothers met with Federal Reserve and Treasury officials at the Federal Reserve offices in New York. At issue was what to do about Lehman. A top Lehman executive reportedly told government officials that Lehman had no idea of the amount of risk on their books in credit default swaps, and then said, "Neither do you." It's astonishing that a top official of a major investment bank would not know the amount of risk that the firm had on its books, but it simply reveals the state of affairs at the time. The Fed did not have any idea about the size or scope of the market, because Alan Greenspan had refused to regulate it even when advised to do so.

Even now, firms are still learning of the risk they have undertaken. This conversation may have been the basis for the decision by Treasury Secretary Hank Paulson to let Lehman file for bankruptcy. Paulson has said that Lehman did not have adequate collateral for a government loan. Based on subsequent events it probably is a decision that he would like back.

Credit default swaps (CDS) are derivatives that are a bet to insure against default of a bond issuer. You do not have to own the bond; you need only be willing to bet. The size of the market is estimated to be $67 trillion, but even that is not certain. The market was, and still is, unregulated. You may not be familiar with these instruments, but they have had a profound effect on everything you own.

Lehman was allowed to go under, and the world has not been the same since. It seems that no one knew or appreciated the fallout from that decision until the consequences spread throughout the world. Treasury was forced to develop a $700 billion (a number that will surely go higher) bailout package to partially deal with the consequences. The amount of money the government has thrown at various solutions to the financial crisis is now about $2 trillion.

The U.S. government has become a giant investment firm. In the long run the government will probably do all right with its investments. It of course had to try to contain the fallout, but it certainly would have been much cheaper if Lehman had been rescued, as repugnant as that might have been.

With the failure of Lehman and Bear Stearns, and the takeover of Merrill Lynch by Bank of America, now Goldman Sachs and Morgan Stanley are the only major investment banks left stand-

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ing. Goldman and Morgan converted to bank status a few days after the Lehman failure, making them immediately eligible for government aid with no questions asked.

The political and policy fallout has been enormous. The Reagan revolution has come to an end. Capitalism as we know it has changed, perhaps irreversibly. The Republicans, advocates of small government and fiscal responsibility, have seen their agenda evaporate. But the Democrats can't waste time pointing fingers (some can be pointed their way too) because they will soon inherit the responsibility of solving the problems left by this crisis. President-elect Barack Obama has his hands full. He will have to be ready on day one.

Business is just beginning to appreciate the consequences of the changes. The government has invested billions in major banks. Some banks accepted this aid willingly and some not so willingly, but it was important that the major banks all be seen to have taken the money so that other banks could take the money without being embarrassed. So banks like J.P. Morgan, which did not need $25 billion, accepted it despite having no clear use for it. Other banks like Citibank were then able to accept the money too, unashamedly. As soon as the banks got their money, other businesses lined up to get theirs. Yet while insurance companies got money, automobile companies did not; however, a proposed merger between Chrysler and General Motors, if it goes through, would have government backing. How will William Ford feel when he finds out that he has the U.S. government as a competitor?

Banks are just beginning to learn what it will be like to have the government as a partner. Calls have already been made in Congress, and from headline-seeking attorneys general, to regulate executive compensation and staff bonuses. (The banks that received the government money are estimated to owe $40 billion to staff for pay, bonuses and retirement benefits.) Socialism will not be pretty.

In the meantime, banks are considering what to do with their newfound wealth. The government has elected to back only winners, and to let the weak ones fend for themselves. Some banks, of course, will fail, but the government hopes that some of the new capital will be used to acquire weaker banks, and

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have even written new benefits into the tax code to make bank acquisitions even sweeter.

But right now the banks, ever cautious, are hoarding the money. They seem reluctant even to do business with one another; therefore interbank lending rates still remain high despite declines. Even President Bush (remember him?) has criticized the banks for not making loans, so it remains to be seen if the taxpayer money that bailed out the banks will make it back to the taxpayers themselves. Will the banks lend to businesses of any size? What about consumers who not only footed the bill for the bailout but also represent 70 percent of the economy – will they get the same generous credit terms that the banks received? Probably not, according to reports out of the Federal Reserve regarding bank-lending practices; taxpayers may just get the hard-knuckle treatment.

Wall Street made billions over the years on dubious business practices. Then when those practices failed, they got billions from taxpayers, to make banks well. We did not give them this money because we love them, but because we had to salvage the system. Reports and anecdotal information is that the banks will not be as charitable to us as we were to them. But banks should prepare for the backlash if they are not responsive. To its credit, J.P. Morgan (disclaimer: it's in our portfolios) has indicated that it will work with homeowners to avoid foreclosures. This is something I called for in this column months ago. Now, maybe others will follow J.P. Morgan's lead.

In the last month our world has changed. Will it be a brave new world?

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