Countdown to the Global Financial Crisis

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A Story of Power and Greed

By

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This book is dedicated to my father, Rosario, from whom I drew much encouragement and inspiration and who always provided well-timed and sage advice.

There are never wanting some persons of violent and undertaking natures, who, for they may have power and business, will take it at any cost.

(Francis Bacon)

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FOREWORD

BY CHRIS WHITEHEAD

CHARTERED BANKER F FIN, CEO & MANAGING DIRECTOR - FINSIA

Unfortunately, history is littered with instances of financial crises, so often driven by greed and, of course, the strong connection that exists between wealth and power. In every instance, it seems that the foundations of sound banking are forgotten, and we rush headlong and lemming-like into the creation of large financial investment schemes based on intangible or obscure assets. We forget the usual disciplines of real security and diversification.

What made the Global Financial Crisis (GFC) different was that the impact of the collapse was not contained to a narrowly defined market—geographically or asset class. It was an unravelling worldwide of trust across financial institutions that very quickly impacted the real economies of nations, regardless of their participation in the underlying causes.

This book provides a fascinating and compelling background to the GFC. It tells the story from a human perspective and the motivating forces behind behaviours, as well as explaining the market dynamics and economic effects. In taking us back to the American War of Independence and following the story up to the collapse of Lehman Brothers, we can see how the seeds of crises are sown.

Ultimately, almost no-one was untouched as the impacts moved into government guarantees for deposits, while property prices collapsed along with securities market impacts. However, some were impacted more than others.

Like the author and many of the readers of this book, I am very conscious of my own personal story. I write this Foreword from the perspective of my current role as Chief Executive of a professional body in financial services. The GFC was the direct driver behind my taking on this role. I had a ‘front-row seat’ to the GFC. As a leader responsible for over 150 branches of a major UK retail bank network I saw first-hand the impacts on customers and staff and felt them personally, alongside all the other bank shareholders. These impacts were personally disastrous; for example, when retiring staff had all their retirement savings as shares in the bank. Insult was added to injury, as bank staff were abused in the media and in the street as government rescues were mounted.

My keenest observation of the crisis from within the banking industry was that we had lost sight not just of prudent management of risk, but of the very purpose for our existence. Above all, I noted that many of the leaders within financial services had no qualifications and little relevant experience in financial services. When some years later, I was offered the opportunity to lead this professional body, a key personal driver was the belief that skills, knowledge and a culture of professionalism were the best defence from re-occurrence of such crises in future.

Hence, I believe that the greatest value in telling the story of the GFC is to maintain awareness of the underlying causes and the corrupting effect that a desire for power and wealth has on financial markets. Our challenge is to contain these forces, to recognise the warning signs and to contain the fallout of future collapses in value of the assets that sit behind financial instruments.

The author has supported the power of these historical observations and the evolution to the GFC with two valuable theories. The explanation of the underlying cause and impact of influences of powers external to industry is of value to all stakeholders, including government and regulators. The explanation of the influence of power brings the element of the individual into focus. This goes directly to culture, and I believe professionalism. Ideally, in a professional environment, self-actualisation could help guard against the adverse impacts of the quest for power on behaviours and risk management. This cannot be relied upon and there is a need for peers to establish a culture that supports sound banking practice and holds individuals to account for their behaviours. Professionalism directly connects behaviours to purpose. It is only through constant clarity of purpose and the vigilance of stakeholders that we can avoid re-occurrence.

I commend this book to readers as a fascinating and enjoyable read, a story, but also a diagnostic that brings clarity to the confusion of an event like the GFC.

ACKNOWLEDGEMENT

I would like to acknowledge and offer my deepest gratitude to Dr Celeste Rossetto for her rigorous editing assistance, support, inspiration and guidance throughout the preparation of this book. Her insightful suggestions have added to the legibility of an otherwise technical topic. I am greatly indebted to her.

CHAPTER 1

INTRODUCTION

Power throughout the ages has been used to drive self-interest by those who hold the reins. This story exposes those who possessed and wielded it to drive the course of history. We are destined to have financial crises and repeat the mistakes of the past whilst greed continues to motivate human behaviour. The USA, a powerhouse of capitalism, has endured a litany of financial crises since the American War of Independence. It is no coincidence then that a pattern of similar influences causing the crises has emerged. Is it possible for the US to ever avoid repeating the same mistakes? As the famous American philosopher, George Santayana, quoted in 1905, “those who cannot remember the past are condemned to repeat it”.

The Global Financial Crisis (GFC), which was the most devastating financial calamity to date, surpassing the Great Depression, originated in the US and peaked during 2008. It significantly impacted the global financial system with dire consequences for the world economy that continues more than a decade later. The resulting social effects touched many individuals, corporations, and political bodies. It also triggered the failure of several large financial institutions including systemically important banks and large investment banks. The most prized scalp claimed by the GFC was also one of the most notorious dealers in the market–Lehman Brothers–whose history is traced in this book and who achieved the dubious title of ‘the largest bankruptcy in history to date’.

Numerous books and articles have been written about the failure of Lehman Brothers, however, what is more interesting is the backstory that begins with the American War of Independence where the US financial system had its antecedents. It is these beginnings that provided a template for the subsequent behaviours within the industry and set the benchmark for posterity.

There are various contributing factors that led to the GFC which are either technical or qualitative in nature. This book analyses certain qualitative factors and explains an often-ignored cause of the GFC which relates to the cultural and behavioural characteristics of individuals and corporations – often described as displaying characteristics of psychopathy – which played a profound role in the years leading to its manifestation.

Looking at historical figures from Haym Salomon (1740-1785), a pioneering financial privateer to the infamous Richard Fuld (1946-), the last CEO and Chairman of Lehman Brothers, it is possible to trace how particular practices and behaviours were tolerated, condoned and persisted across the US financial landscape. An understanding of the evolving culture and practice of the investment banking industry is assisted by the historical context. Profiles and behavioural characteristics of a sample of historical personalities are provided to describe practices within the investment banking industry which are found to persist up to the pre-GFC period. These personalities are placed alongside certain historical events such as economic crises and trends. The following chapter begins with the American War of Independence and finishes at the War of 1812 between the British and the US. Subsequent chapters trace the investment banking crises through the nineteenth, twentieth and twenty-first centuries up to the GFC. Ultimately, the historical influences help explain the industry's modern-day *modus operandi*.

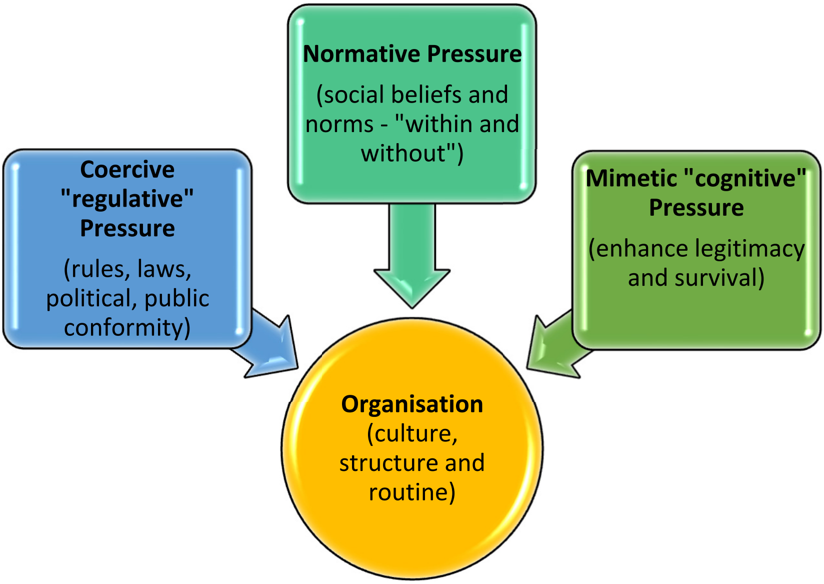
The story we tell in this book is told from a particular viewpoint that is underpinned by two theories that will now be briefly explained and for the purpose of this book, simplified. The first, New Institutional Theory, is concerned with the application of external institutional forces on the industry (DiMaggio and Powell 1983). The second is the Theory of Power (Clegg 1989) that helps to clarify why individuals throughout the history of the investment banking industry behaved in specific ways. Those risk-taking personalities seized opportunities that shaped organisations and decision-making processes and made themselves wealthy and often respected in the process.

To offer a bit of detail about these theories will increase the enjoyment of the story. New Institutional Theory argues that institutions are social structures that are highly resilient, are understood within a culture, are normative in nature (they tell us what we should do), and are regulated, that is, they are enforced. These social structures are communicated in the field through symbols, relationships, routines and artefacts. They provide stability for organisations, and operate at both the global and organisational levels.

This theory helps us understand how the social structures of the investment banking industry at the global level and at the organisational level, as in the case of Lehman Brothers, are created, adopted, adapted and in time, fail or change. The investment banking culture had developed a commonality. This culture established a structure of internal morality for behaviours and practices that were evident prior to the GFC as the next chapter will illustrate. These behaviours and practices were socially justified in view of their common usage within the industry and in the shared motivations of individuals which was dominated by the maximisation of profits and bonuses.

The universe of organisations is heavily influenced by 'institutionalised isomorphism', that is, organisations incorporate operational structures, policies and practices which are similar within a particular field. This type of conformity appeals to the perception that 'normal' practice is risk averse and accrues legitimacy in the eyes of stakeholders, however, perception may differ from reality. New Institutional Theory comprises three classifications; coercive, mimetic and normative institutional forces to explain key drivers that affect decision-making at the firm, industry and regulatory levels of investment banking**. Coercive factors** involve any coercion by an institution, often in the form of governmental power and political influence to generate outcomes consistent with the will of the state and political pressure groups. **Normative factors** emanate from the influence of the profession to conform to the best practice for its field and through the education system used to train the professionals. **Mimetic forces** act on agents when they succumb to the safety of long-accepted practices and choose to mimic others when dealing with decisions in times of uncertainty. The following diagram offers a simple image that clearly illustrates the application of the three institutional forces.

Figure 1.1: New Institutional Theory Framework



A well-known theorist, Stewart Clegg, explains power as emanating from and progressing through three circuits: the episodic, dispositional and facilitative. The **episodic circuit** is where power is exercised on a daily basis through communications, feelings and conflict and enabled by resources such as time, wealth, position, commodities, or knowledge. Within this circuit, social relations are shaped by the interaction where power is exercised or contested.

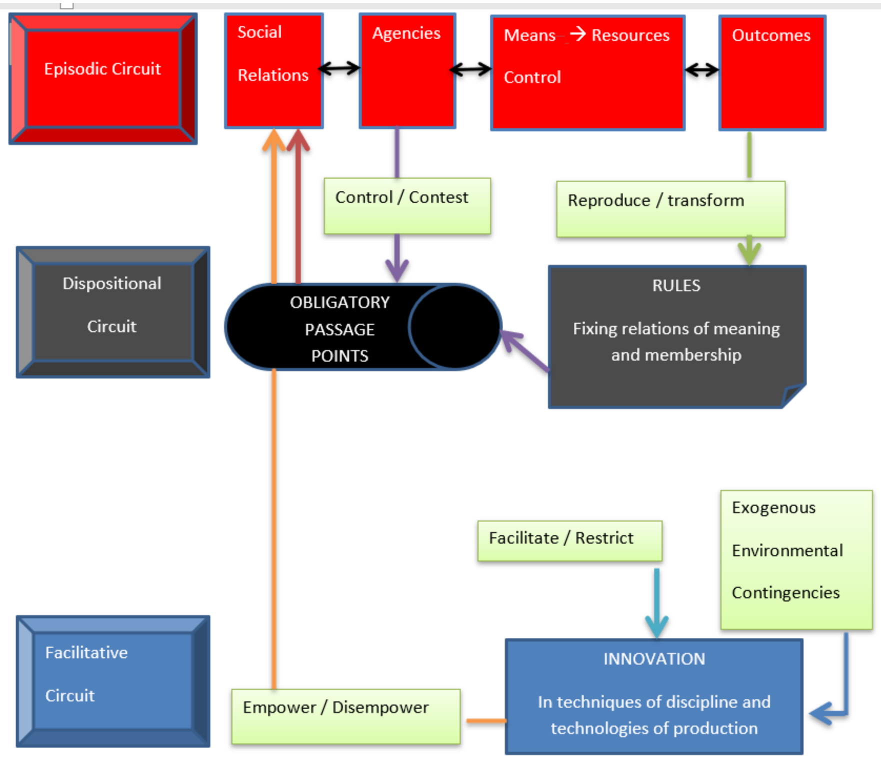
The **dispositional circuit** is primarily concerned with the formation and continuation of a member's standing and power within the organisation and the relevant rules to which they are subjected. Meaning is therefore provided to an organisation through these rules and policies which can undergo a process of constant change thereby potentially altering the balance of power within social relations. Various communication channels are essential for these rules to be established and changed when necessary.

The final circuit, the **facilitative circuit**, deals with technology, environmental contingencies, job design and networks. (Clegg 1989, 233). An example to describe how technological innovation can affect power could be the automation of certain manufacturing processes which were previously carried out by skilled workers. The obviated skills disempower those affected employees whilst the employees responsible for the ongoing maintenance of the automated systems become empowered. The use of job design and networks are useful in applying power both at the regulatory level and through internal relationships within the investment bank. This level of power has the potential to reconstrue organisational morality and transform previously deemed unacceptable behaviour into acceptable behaviour.

The flow of power through Clegg's (1989) three circuits operates through channels known as "obligatory passage points" that are likened to conduits which allow the conveyance of empowerment or disempowerment. These flows are represented in the following diagrams.

An example of how the circuits of power model operates is located in a study conducted by Crozier (1964). He analysed a tobacco factory which relied on machines maintained by maintenance workers. These machines were controlled by production staff whose bonuses were dependent on the success of the maintenance workers keeping the machines operational. Without the co-operation of the maintenance workers, the ability of the production staff to succeed in their roles and hence generate bonuses was limited. The highly bureaucratic state-owned tobacco factory's operations were centred on the production staff whose formal standing in the organisational hierarchy was much higher than the maintenance workers. However, the power of the maintenance workers over other staff was superior in view of their control over the production outcomes on which the production staff performance was measured. Management, including the production staff, attempted to resist this power by instituting a program of preventative maintenance. In response, maintenance workers destroyed work manuals and machines were occasionally decommissioned by them regardless of their operational functioning. This example shows how technical knowledge and skill empowered workers who were otherwise low in the formal structural hierarchy of an organisation. Their knowledge of the production process empowered the maintenance workers to overcome the formal power held by others in the organisation (Clegg 1989, 236). The maintenance workers effectively possessed a degree of power by way of technical knowledge and skill depicted as the "technology of production" located in the facilitative

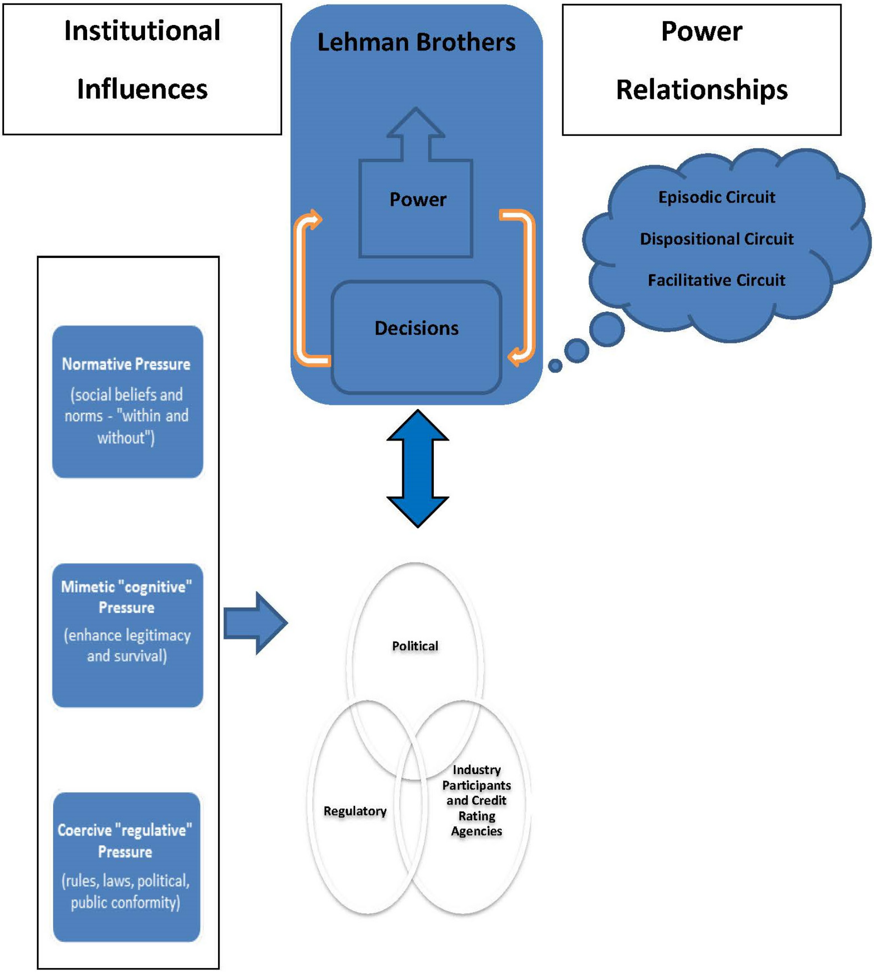
Figure 1.2: Diagram of Clegg's Circuits of Power



Circuit of Clegg's (1989) model. The resultant power was transmitted through an obligatory passage point-the process being represented by the destruction of the operational manuals which were instruments vital in management's attempts at diffusing the relative control of the maintenance workers. The resultant effect in the dispositional circuit was to change the significance and meaning of maintenance work. The workers' power in the episodic circuit was also enhanced as their everyday actions involved more control over production resources, pay rates and bonuses. Conversely, changes in "technology of production" can render certain skills redundant, thus disempowering the affected individuals.

Neither DiMaggio and Powell's New Institutional Theory or Clegg's Theory of Power on their own can fully explain the machinations within the investment banking industry. However, when one is augmented with the other, all the dysfunctional outcomes can be explained.

Figure 1.3: An Institutional View of Lehman Brothers Impacted by Three Circuits of Power and Institutional Influences



The application of a theoretical lens over historical events, documents and characters is aimed at generating a rich understanding of the cultural and behavioural aspects that led to Lehman Brothers' failure rather than a mere technical analysis which has permeated the literature relating to the GFC. This method explains rather than predicts events, behaviours and actions of actors to offer insights within the historical and social contexts.

This book assumes a non-realist ontological stance, that is, the culture of investment banking is socially constructed and socially constructing (Chua 1986; Hopwood 1987; Hines 1988). It is argued that regulations covering financial institutions, such as accounting standards and the reliance on credit rating agencies are a socially constructed phenomenon, dependent on people for their existence and use, interpretation and perpetuation. Additionally, investment banks that operate within their regulatory framework are reliant on individuals' decision-making occurring within a business model that is bound by a set of internal rules and policies which are shaped by an organisational hierarchy and influenced by the regulatory environment and individuals' capacities. This book emphasises the importance of recognising the social, political and economic contexts to explain the how, why and who of the event (Burrell and Morgan 1979; Chua 1986; Hopwood 1987; Gioia and Pitre 1990; Hassard 1991). An awareness of the contextual nature of the inquiry is fundamental to this approach (Dillard 1991; Hassard 1991) and will extract the presences, as well as the silences, and absences of power, its uses, and institutional influences in and between the various organisations. It also identifies who were the power holders, those subjected to power and how power was exerted.

Whilst this book is divided into four distinct parts, there are three major themes that provide a leitmotif throughout the book. These are the reliance on key relationships with government authorities and officials; influence through formal, personal and commercial networks; and the impact of personal characteristics and organisational culture.

Part 1 outlines the birth and development of the US investment banking industry from its antecedents during the American War of Independence up until the GFC. It covers the essential role of bankers the quasi-Treasury to the government during war-time; rapid growth during the railroad expansion; and the opportunities and challenges during the early part of the twentieth century which covered financial crises and regulatory impositions. The British colonials rose up against Great Britain to assert their political freedom to govern themselves. The banking system had close ties with Europe, especially France and it was through the connections of certain entrepreneurial individuals that the war was financed. In order to fund the next war against the British in 1812 the government relied on firms, such as S & M Allen & Co., that had an enviable distribution. However, further financing was required so individuals, such as Albert Gallatin, Secretary to the Treasury, issued bonds to raise additional capital.

As the century rolled on, the introduction of the railroads to move people and goods more swiftly and efficiently, saw entrepreneurs turn to Europe for funding. Individuals who had education, backgrounds in the military, government or banking with connections in Europe proved valuable when trying to access funds for these large infrastructure projects. Whilst the country benefited from an expanding, efficient transportation system, so did the entrepreneurs who invested in this risky business. It is at this time when the "revolving door" between the government and the investment banking industry becomes more overt – a behaviour that became embedded within the industry.

It behoves investment bankers to exploit business opportunities, especially when profit beckons. The pattern of bankers profiteering from war continued. The Civil War was costly to both the North and the South but the agrarian South was unable to raise the necessary funds through taxes and exports, leading to its inevitable defeat. The North, whilst challenged, fared better due in no small part to the expertise of its bankers such as Salmon Chase and Jay Cooke.

In the nineteenth century, the investment banking industry had two competing groups of bankers known as "Our Crowd", that comprised Jewish firms and the "Yankee Houses" that were non-Jewish. As the use of lending syndicates to fund major transactions became more important, so did these alliances. Members within each group supported each other to prosper and as their wealth accrued so did their power. However, it was not plain sailing for bankers as the turn of the century ushered in the Panic of 1907 and public pressure was brought to bear on these powerful investment banking giants through regulations. The abundance of funds in the 1920s created asset bubbles that led to the famous Wall Street Crash of 1929, so once again, the legislators stepped in. A raft of regulations was subsequently introduced that changed the balance of power. As the investment banks morphed from a partnership to a corporate structure in the years following WWII, the investment banking industry relied less on the tacit skill and reputation of individuals and their firms. The benefits of limited liability afforded to a corporate legal structure combined with an increased level of merger and acquisition activity amongst the investment banks created larger organisations with greater access to capital. Investment banks were therefore prepared to take on the high costs of litigation allowing the regulatory pendulum to swing in the banks' favour. This enabled a powerbase to increase enough to successfully drag the US Government through the courts. The result ensured that the industry was not overly hindered by hard-line financial regulation.

Part II of this book outlines a chronological history of Lehman Brothers, highlighting events and personalities that have contributed to the development of the firm. It explores the individual and institutional machinations, influences, power relationships and pressures which helped shape Lehman Brothers and led to its final demise. The book divides Lehman's history into two eras. The first covers its foundation by the three Bavarian brothers who emigrated from Germany and concludes with the anointment of Richard Fuld as CEO and chairman. The second era of Lehman's history represents the period when the firm was under Fuld's dysfunctional leadership, which ultimately led to its bankruptcy. Part II further examines Lehman Brothers' business model and financial structure and draws similarities with its peers hinting at systemically ingrained deficiencies. It also investigates the role that hubris played in its dying days.

Part III revolves around connections and influence between the investment banking industry and the financial network. This network encompasses the US government, the various financial industry regulators, lobby groups, credit rating agencies and other financial institutions. They make for good bedfellows at times of convenience. The book provides relevant information that offers solid evidence of how lobbying, political pressure, knowledge asymmetry and the influence exerted over the Financial Accounting Standards Board (FASB) coalesced. This influence is highlighted in the book by a discussion of the influence exerted over the FASB in changing their draft accounting standard for repurchase agreements. Lehman Brothers seized on this opportunity to apply a loose interpretation of the standard to window dress its financial statements. For Lehman Brothers, concealment became the order of the day which contributed to