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Ten Years On – A Reflection

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“With Lehman filing for bankruptcy, Merrill falling into the arms of B of A, and AIG scrambling to announce a restructuring plan, investors had their hands full to start this week. The Dow dropped 500 points as the Fed refused any Bear-type rescues. Now it may be morale hazard.” – On The Left, September 15, 2008.

With the headline ‘*Is It Friday Yet*?’, so began our predecessor newsletter commentary on that fateful Monday a decade ago. Little did we know how much those unthinkable events, and the extraordinary regulatory and legislative intervention that followed, would change world financial markets. And the way those markets forever after perceive risk.

As the tenth anniversary of Lehman’s fall approaches this week, there’s been much in the media about what happened to precipitate the Great Financial Crisis. Do we understand its implications, and have we made the appropriate changes in structures and behavior to defend against something similar occurring again?

The primary culprit for the crisis – weak underwriting standards for sub-prime mortgages – has been largely addressed. Another fault line – a poorly capitalized banking system – has also been alleviated, thanks to more Tier I capital raising.

There are certainly other macro lessons. Included on our list, for example, is not relying on short-term bank lines for your firm’s liabilities, avoiding mark-to-market asset valuations, and diversifying your financing sources.

Today credit risk analysts are on the lookout for bubbles. In LBO land, it’s not loan prices but high purchase price multiples and debt-to-ebitda ratios being scrutinized. Observers worry that while Dodd Frank lessened the risk of banks holding “risky loans,” it’s done nothing to check the same behavior in the shadow banking universe.

For their part, less-regulated firms say managers have real skin in the game. Paper is held, not distributed. And third-party investors are sophisticated institutional funds whose portfolios include a broad spectrum of debt and equity instruments.

A recent WSJ piece (“Lehman’s Lessons, 10 Years Later”) highlighted five lessons learned. But at the end it cited one overarching principle from John Kenneth Galbraith: “As a protection against financial illusion or insanity, memory is far better than law.”

That’s something our partners have in abundance. For them, while the last recession was brutal, it’s only one of a number of business cycles they’ve been through. They remember (for better or worse) the details of every past market and deal hiccup. Those memories govern today’s credit decisions.

It’s impossible to predict whether financial rules and laws imposed since September 2008 will apply for the next crisis. What is clear, though, is that managers will do what they can to protect themselves against things they can’t control, and use their skills and experience to protect themselves (and their investors) against the things they can.