

Letting Lehman Go: Critique, Social Change, and the Demise of Lehman Brothers

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Veröffentlichungsversion / Published Version

Zeitschriftenartikel / journal article

Zur Verfügung gestellt in Kooperation mit / provided in cooperation with:

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Empfohlene Zitierung / Suggested Citation:

Dosdall, H., & Rom-Jensen, B. Z. (2017). Letting Lehman Go: Critique, Social Change, and the Demise of Lehman Brothers. *Historical Social Research*, 42(3), 196-217. <https://doi.org/10.12759/hsr.42.2017.3.196-217>

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Historical Social Research Historische Sozialforschung

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Letting Lehman Go: Critique, Social Change,
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doi: 10.12759/hsr.43.2017.3.196-217

Published in:

Historical Social Research 42 (2017) 3

Cite as:

Henrik Dossdall, and Byron Z. Rom-Jensen. 2017. Letting Lehman Go: Critique, Social Change, and the Demise of Lehman Brothers. *Historical Social Research* 42 (3): 196-217. doi: 10.12759/hsr.42.2017.3.196-217.

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doi: [10.12759/hsr.42.2017.3.196-217](https://doi.org/10.12759/hsr.42.2017.3.196-217)

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Letting Lehman Go: Critique, Social Change, and the Demise of Lehman Brothers

Henrik Dossdall & Byron Z. Rom-Jensen *

Abstract: »Lehman fallen lassen. Kritik, sozialer Wandel und der Untergang der Lehman Brothers«. The collapse of the U.S. investment bank Lehman Brothers marked the escalation point of the financial crisis of 2008. Yet, while the consequences of the collapse are widely discussed, the developments that led to Lehman Brothers' demise have yet to be dealt with from a sociological perspective. In this paper, we tackle this research gap by asking why Lehman Brothers – as opposed to other ailing banks – was not saved by the US regulators. We will show that mounting pressure from public opinion caused a shift in the risk perception on the side of the regulators. Initially oriented towards the economic risk associated with a potential failure of Lehman Brothers, the critique of the 2008 bailouts prompted regulators to weight the political risks of further bailouts over the economic risk of the bank's collapse. Thus, we argue that the social change brought about by the collapse of Lehman Brothers was critique-induced.

Keywords: Lehman Brothers, disaster thresholds, risk perception, public opinion, financial crisis of 2007, social change.

1. Introduction

When the United States investment bank Lehman Brothers filed for bankruptcy on Monday, September 15, 2008, its failure was the largest in U.S. corporate history. Exceeding even the losses following the Enron and WorldCom bankruptcies at the beginning of the millennium, Lehman Brothers' collapse led to the lay-off of 26,000 employees, triggered 80 insolvency proceedings of its subsidiaries in eighteen countries, and resulted in more than 66,000 claims on its insolvency estate (FCIC 2011, 339f.). As a consequence of Lehman's collapse, the trajectory of the financial crisis of 2007 moved towards "cataclysmic proportions" (FCIC 2011, 343). Thus, the failure of Lehman Brothers presents a transitory event connecting two different stages of escalation during the fi-

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nancial crisis. Yet, despite the significance of Lehman's demise, surprisingly little sociological attention has been paid to analyzing why Lehman collapsed in the first place. This article addresses this research gap.

One obvious approach to determining why Lehman Brothers failed is to focus on the economic losses the bank suffered in 2008. Yet, such a line of inquiry promises only limited insights, as Lehman Brothers' business model – highly leveraged investments in the real estate market – was anything but unusual (Valukas 2010, 3). In the end, Lehman's survival – as the survival of almost all other financial organizations – was threatened by losses in the deteriorating housing-market.¹

A more promising starting point exists in the exceptional approach that regulators took during Lehman Brothers' collapse compared to other too-big-to-fail banks. Initially, when these banks neared insolvency at the beginning of 2008, the regulators stepped in to prevent their defaults, in the process rescuing Bear Stearns and Fannie Mae as well as Freddie Mac. However, when Lehman Brothers faced similar circumstances that September, the regulators abandoned this practice, effectively letting the bank go – despite Lehman's comparable size to the rescued institutions. Thus, the defining characteristic of Lehman's default lies in the *absence of regulatory intervention*. Consequently, we will not focus on why Lehman Brothers failed economically, but on why Lehman Brothers was not saved politically.

Drawing upon the concept of disaster thresholds (Japp 1997, 2003), we will argue that the developments leading to the absence of regulatory intervention in the bankruptcy of Lehman Brothers were critique-driven while its outcome was a substantial social change in the course of the financial crisis of 2007. More precisely, the following sections will show that the bailouts that preceded Lehman Brothers attracted such a high degree of criticism that another intervention in favor of an investment bank presented a political risk the regulators were no longer willing to accept. Accordingly, we confine our notion of critique to the political sphere – instead of a more encompassing social criticism (cf. Boltanski 2010) – where we conceive of critique as the opposition of media and political actors in public opinion to a specific course of political action. Social change, on the other hand, is understood as the change of expectations (Luhmann 1984, 470ff.), which designates in our case the change of pivotal expectations in finance. Despite its modesty, this definition proves helpful in explaining that the absence of regulatory action in the case of Lehman Brothers significantly exacerbated the crisis by undermining the expectation that at least those banks considered too-big-to-fail would be saved through government support. Building upon these definitions, we contend that Lehman Brothers presents a case of *critique induced social change*.

¹ In this sense, Lehman's bankruptcy indeed represents the "collapse of a system" (Villechenon 2013).

Transcending the limits of the empirical case, we argue that, in spite of the renewed sociological interest in financial markets (cf. Knorr-Cetina and Preda 2005, 2012), critique inspired social change, or, more broadly speaking, social dynamics, are an important, yet thus far neglected, aspect in the analyses of financial crises. Thus, our approach departs from the general penchant for describing economic mechanisms as the major driving factor of the subprime-crisis. We challenge this sociologically unsatisfying view by highlighting the social dynamic in what became the most defining moment of the subprime-crisis.

To develop our argument, we first review the existing literature on Lehman Brothers (2). Next, we analyze the “too-big-to-fail” doctrine and interpret it as a disaster threshold (3), before examining public opinion as a medium of political self-observation (4). Subsequently, we reconstruct the critique that followed the 2008 bailouts (5). This leads us to a discussion (6) and a conclusion (7) that considers the relationship between critique and social change.

2. Lehman Brothers

The most thorough sociological analysis of the role of Lehman Brothers in the subprime-crisis is presented by Richard Swedberg (2010). Swedberg argues that Lehman Brothers represents a case in which the “proxy signs” of the financial markets, that is signs informing investors about the creditworthiness of a bank (i.e. the judgements of the rating agencies), ran counter to the actual situation at the bank. This resulted in “hidden losses” unknown to the public. As soon as the markets learned of this discrepancy, they lost trust in the validity of the proxy signs, assuming that most banks shared these hidden losses. In this regard, Lehman Brothers “touched off” a loss of confidence, thereby contributing to the evolving crisis (Swedberg 2010, 103). While Swedberg vacillates somewhat as to the exact role that the default of Lehman Brothers played in the unraveling of the markets, journalists were less reticent. Mollenkamp et al. (2008) for example, claim that Lehman Brothers presents a “turning point” in the financial crisis, as it triggered a “cash crunch around the globe.” Political scientists likewise emphasize Lehman Brothers’ turning point character (Mayntz and Streeck 2010). However, from their perspective, this turning point ushered in the “return of the state” (Mayntz 2010) as Lehman Brothers necessitated interventions by the political authorities in the very markets thought to be best served when left to their own devices.²

The approaches depicted so far converge in their neglect for the question of why Lehman Brothers was not saved. This is especially evident in arguments

² See Piketty (2013, 755) for critical remarks with regard to this discussion.

that implicitly assume that Lehman Brothers lacked “too-big-to-fail” status and therefore was never considered worth saving (cf. Carruthers 2011, 249). However, such assumptions run counter to the regulators’ actual efforts to save the bank (cf. Valukas 2010). Accordingly, the Financial Crisis Inquiry Commission, appointed by the U.S. government to investigate the causes of the crisis, concluded that a host of factors, including moral hazard concerns and fear of the public reaction, influenced the regulators’ decision to let Lehman go (FCIC 2011, 343). British historian Niall Ferguson also endorsed this view in a *Financial Times* article that attributes the decision not to bail out Lehman Brothers to the Treasury Secretary’s resolve to “stop being Mr. Bailout” (Ferguson, 2009). Ferguson’s remarks are representative of a whole body of work, mostly journalistic in nature, that speculates on the regulators’ intentions to not rescue Lehman Brothers (cf. Taibbi 2010). However, while we agree in part with the conclusions of these approaches, they lack a proper understanding of the dynamics of the events of 2008 and thus fall short of adequately explaining why the regulators refused to bailout the fourth largest U.S. investment bank in an already fragile market environment. We now turn to these dynamics by analyzing the too-big-to-fail doctrine as a disaster threshold.

3. Disaster Threshold: Too Big to Fail and Its Political Risks

From a regulator’s perspective, in times of financial crisis

[...] the authorities have strong incentives to prevent the failure of a large, highly interconnected financial firm because of the risks such a failure would pose to the financial system and the broader economy (Bernanke 2009).³

In other words, some organizations are too-big-to-fail and thus eligible for government bailouts.⁴ Historically, the liberalization of financial markets through the deregulation of the 1990s – including the relicensing of interstate banking and the repeal of the Glass-Steagall Act prohibiting commercial banking activities in investment banks – abetted the emergence of these too-big-to-fail organizations.⁵ Similar to other periods in financial markets (Stearns and Allan 1996; Stearns and Mizruchi 2005, 286f.), these deregulations encouraged a “merger wave” of institutions pursuing a strategy of vertical integration with regard to the real estate market (FCIC 2011, 89). Between 1990 and 2005 alone, 74 mergers occurred involving banks with assets exceeding \$10 billion

³ The term likely originated in 1984 during the rescue of the Continental Illinois National Bank and Trust Company (Dash 2009; Geithner 2014, 213).

⁴ Insofar, too-big-to-fail organizations resemble “permanently failing organizations” (Meyer and Zucker 1989) in that they also attract such a high interest in their survival that they can endure life-threatening economic losses.

⁵ For a comprehensive description, see: Hendrickson 2001 and Krippner 2010.

each (FCIC 2011, 52). The result was that some banks entered the regulators' lexicon as too-big-to-fail. The most visible instance of too-big-to-fail took place when the hedge fund Long Term Capital Management (LTCM) found itself teetering on the brink of collapse in 1998 after the Russian government defaulted on its debt. While the Federal Reserve did not directly save LTCM, it orchestrated a bailout by a consortium of Wall Street banks (Lowenstein 2002).

From a theoretical perspective, we interpret too-big-to-fail as a disaster threshold on the side of the regulators (Japp 1997, 2003; Rescher 1983). By disaster threshold, we refer to the difference between acceptable and unacceptable risks, the former lying within the "ordinary range" of a specific observer, the latter being a potential disaster "that is altogether unacceptable" (Rescher 1983, 70). That this latter eventuation must be avoided "at all cost" (ibid., 72) makes the difference between risk and disaster a matter of *acceptance*. Thus, disaster thresholds are effectively "decision rules" that trigger an "avoidance imperative" (Japp 1997, 302), aimed at preventing what is perceived to be the looming disaster.

It is important to stress that the term disaster does not denote the objective consequences of damage, but instead the necessarily subjective attribution of an observer (Japp 2003). Having said this, it should be clear that disaster thresholds are also subject to change. A central mechanism in this regard is the *emergence of a new risk that leads to a re-evaluation of what is still an acceptable risk and what is already an unacceptable disaster* (Rescher 1983, 68). Put differently, emerging risks, if severe enough, have the potential to demote former disasters to acceptable risks. In the next section, we discuss this dynamic with regard to the regulators by turning to public opinion as a medium through which political actors observe the repercussions of their decisions.

4. Public Opinion and Political Risk

Following Luhmann, we assume that the political system, like other systems of modern society, replaces the direct and immediate observation of its environment with a modus operandi in which observers observe other observers (Luhmann 1997, 2000). More precisely, this means that political actors⁶ do not observe their electorate directly, but instead observe the reactions of other political actors to their own actions.⁷ In this vein, the political system operates in the same manner as markets. On the latter, "rather than dream about buyers,

⁶ We use the term political actors to avoid the misinterpretation that only professional politicians observe themselves in public opinion. Instead, whoever finds media attention and attracts political note can be observed in public opinion (Luhmann 2010, 445).

⁷ Exceptions exist, of course, especially when politicians become involved in direct interaction with their potential electorate, such as during a campaign for political office.

firms watch their competitors” (White 2008, 238).⁸ However, while market-based observation concerns itself with market shares and the associated monetary gains or losses, political self-observation concentrates on the fluctuations of political support.⁹

The precondition for this political self-observation is the existence of public opinion, which functions as the medium of assessing political support (Luhmann 2000, 287).¹⁰ Yet, as the prefix “self” already suggests, public opinion does not permit an observer to “look through” to the other side of the political audience’s individual opinions (Luhmann 2000, 284). Instead, public opinion is a mirror, allowing political actors to *only* observe themselves in the context of others (Luhmann 1992, 2005, 181f.; 2000, 274ff.). The actual opinion of the political audience remains behind the mirror and thus unobservable.¹¹ Therefore, when the regulators assessed the political backlash of the 2008 bailouts, they did so by observing the reactions of other political actors – as presented in the media. This points to the significance of the media, while at the same time reiterating that public opinion is devoid of any reference to the level of individual opinions (Luhmann 2005, 172).¹²

Political self-observation in the mirror of public opinion has “disciplining effects” on political actors (Luhmann 2000, 291) due to the necessity that every political decision has to be represented in public (Japp and Kusche 2004). In this sense, public opinion endows political actors with points of orientation regarding the political consequences of their decisions (Japp and Kusche 2004, 520). At the same time, the effect of this “boundedness to representation” (Japp and Kusche 2004, 525) is that public opinion imposes constraints on political decision making (Gerhards 1994, 80; Münch and Schmidt 2005, 208): the higher the political risk of a decision, the lower the chance that such a decision is actually taken. Thus, by exposing political decisions, public opinion tends to restrict the range of political actions to those not entailing significant losses of political support. However, the degree that this mechanism applies depends on a decision’s visibility, measured in the reactions it will provoke from other political actors. Typically, small scale or technical decisions have a good chance of escaping critical assessment as they attract only little attention. Con-

⁸ For an overview, see: Luhmann 1992, 81.

⁹ Thus, the possibility of political opposition is preconditioned on the existence of public opinion as a means of political self-observation (Luhmann 1998, 2000, 302).

¹⁰ In this sense, public opinion is a special case of a more general public (Luhmann 2004, 187). See for the emergence of the latter Habermas 1990.

¹¹ Provided, of course, that these actors can access the realm of public opinion in the first place.

¹² Furthermore, the collective singular “public opinion” must not obscure that the term actually describes a variety of different opinions. Public opinion is neither a uniform nor an aggregate opinion of the political audience. Instead, the term is tautologically constituted: public opinion is what is described and observed as public opinion (Luhmann 2000, 286).

versely, the high visibility of a political decision correlates with an equally high degree of vulnerability to critique.

Bailout decisions are fraught with high political visibility due to their attractiveness for both the mass media and the political system. With regards to the media, this attractiveness results from bailouts displaying a variety of ‘news values’ – such as huge quantities of money (Luhmann 1997, 1099; 2004, 59; 2005, 178), discontinuity (Luhmann 1971, 17; 2004, 58), and conflicts (Luhmann 2004, 59) – all propelling media attention. Additionally, the necessity for bailouts usually contains the spectacle of hubris, as a profession that is often assumed to project a “masters of the universe” self-understanding has to plea, hat in hand, for government support – or so the public narrative goes. Irrespective of the sociological quality of such depictions, they help explain why bailouts receive so much media attention.

For political opponents, bailout decisions are likewise attractive, as they offer a huge potential for critique and a subsequent reordering of the political landscape. This critique-generating character of bailout decisions is due to at least four features. First and foremost, bailouts entail significant political risks due to the investment of taxpayers’ money to save private for-profit organizations, almost automatically stoking the criticism that “profits are privatized while losses are socialized.” Compounding this issue from a regulator’s perspective, the too-big-to-fail doctrine dictates a high degree of indifference towards moral questions: the potential support for a bank is conditioned by the bank’s size, not its business ethics. This deprives regulators of the ability to justify their decisions on moral grounds. A third characteristic results from the bipartisan U.S.-American support for a neoliberal agenda that promotes market self-regulation. Hence, bailouts entail a significant reputational risk (cf. Power 2004) for the regulators, as they are, by definition, interventions in the market and thus in stark contrast to the overall orientation of economic policy.¹³ Furthermore, as soon as regulators intervene in the market, they actively decouple organizational belief from organizational action (Brunsson 1989), thereby *visibly* attesting to the alleged hypocrisy of such policy. A final point of political vulnerability stems from the moral hazard constellations caused by bailouts (Kindleberger and Aliber 2005, 204f.). Moral hazard, in this context, is the threat that saving some banks will lead similarly-sized banks to assume that they are also eligible for help under the too-big-to-fail doctrine. Consequently, these banks tend to take greater risks than they otherwise would. Moreover, the prevalence of this belief creates incentives for banks to become large enough to be too-big-to-fail (Bernanke 2009). In what follows, we will subsume these risks under the term *political risk* as they result from the *critical observation of*

¹³ Maybe the most famous semantic reaction in this regard is the remark by Ben Bernanke that: “There are no atheists in foxholes and no ideologues in financial crises” (Baker 2008). Clearly, the statement is meant to overrule the ideological pitfalls bailouts present to regulators.

and opposition to bailouts by other political actors, thereby creating the potential to reduce voter support.

Notwithstanding these risks, the existence of the disaster threshold demonstrates that for the regulators, the political risks of bailouts are, under normal circumstances, subordinate to the economic risks resulting from the collapse of too-big-to-fail banks. Furthermore, the avoidance of the assumed economic disaster grants legitimacy to bailouts that helps to fend off the political risk associated with such regulatory action.¹⁴ However, just as the effects of bailouts are cumulative, in that more bailouts require more taxpayers' money, so too are the political effects of critique, as they accrue to a point where economic risk may be considered secondary to the potentially disastrous political consequences.

5. The Dynamics of Critique in 2008

The last section theoretically asserted our claim that critique bears upon political decision making by setting constraints on future decision making. In this section, we will empirically demonstrate how the critique of further bailouts intensified over the course of 2008 and guided the regulators' decisions. To this end, we reconstruct the according coverage in the *New York Times* (*NYT*) and the *Wall Street Journal* (*WSJ*). Three considerations influenced our choice of these newspapers. First, both enjoyed widespread readership among the three prominent actors involved in bailout decisions, namely: the Federal Reserve (Fed), the Federal Reserve bank, and the US Treasury (Paulson 2013; Geithner 2014; Bernanke 2015). Second, print media has traditionally boasted the strongest impact amongst non-elected officials (van Belle 2003), such as the regulators housed within the Fed. Third, the *NYT* and the *WSJ* are largely representative of a wider spectrum of media outlets, despite representing only a fractional part of the financial crisis coverage. Furthermore, by employing financial reporters known to be the "best equipped to understand" (Bernanke 2015, 296) federal decision making, these newspapers help orient other, less versatile, newspapers.

To formulate the narrative of media critique, we gathered and indexed articles from the *PROQUEST Historical Newspapers* database with a preference for editorials and commentary. The selected articles (45 from the *WSJ* and 41 from the *NYT*) were then classified based on their assessment of liability for the current financial crisis (e.g.: hedge fund managers, investment bankers, government regulators, Congressmen). The result demonstrated a media critique

¹⁴ Only a few legitimacy formulas are robust enough to justify interventions in favor of banks; namely, referencing the size or interconnectedness of banks. A patriotic investment strategy, in comparison, does not suffice cf. Geithner 2014, 145.

that developed in reaction to the regulators' bailout policy and which subdivides into three stages of intensity.

5.1 "A Bipartisan Affair in Town"

On July 31, 2007, two hedge funds of the U.S. investment bank Bear Stearns filed for bankruptcy. For several months, the funds had faced mounting troubles due to their subprime exposure and, even worse, the perception of these troubles amongst lenders. Although Bear Stearns spent \$1.6 billion to try to save them, both collapsed as a run on the funds eventually undermined their liquidity (FCIC 2011, 134ff.). In the media, journalists and experts debated the magnitude and meaning of these events, and whether the bankruptcies were a "market event" or a more limited case of executive mishandling (Kate and Mollenkamp 2007; Saha-Bubna 2007a, 2007b). While the meaning of the bankruptcies was contested in the face of mounting uncertainty about the unfolding crisis (Alster 2007; Norris 2007; Shrivastava, Blumberg and Saha-Bubna 2007; Sloan 2007; Bajaj 2007; Morgenson 2007), the failure of two hedge markets was hardly a too-big-to-fail situation requiring government intervention. This kept the regulators out of the press and led newspapers to limit their critique to the financial institutions and the managers of the Bear Stearns' hedge funds. In response, the Bush White House limited their press exposure, taking a hands-off approach to events on Wall Street.

During the rest of 2007 and into 2008, the situation worsened at Bear Stearns. Facing the ramifications of the hedge funds' collapse and a deteriorating market, Bear found itself on the verge of bankruptcy in March 2008. Unlike its hedge funds, from the regulators' perspective, Bear Stearns was "too-interconnected-to-fail" (Geithner 2014, 151). For that reason, the regulators brokered a deal whereby J.P. Morgan acquired Bear Stearns, with the government facilitating by creating an entity called Maiden Lane to buy most of Bear's toxic assets.¹⁵ To do so, the regulators evoked – for the first time since the Great Depression – section 13 (3) of the Federal Reserve Act, which allowed loans to non-depository institutions, like investment banks, under "unusual and exigent" circumstances. Only then did J.P. Morgan buy Bear Stearns at \$2 a share (FCIC 2011, 290).¹⁶

The media reception of this perfunctorily private deal – the Fed guaranteed more than \$28 billion – was tepid. The *WSJ* proved the more critical of the deal, decrying the risk of ensuing "moral hazard" and danger to the taxpayer. This criticism could be particularly scathing towards the regulators' decision to assume risk, which the *WSJ* described as dishonest "socialism" (Wall Street Journal 2008a). The *NYT* was more contradictory, condemning the "extent to

¹⁵ Maiden Lane is a street close to the New York Fed.

¹⁶ The price was later increased to \$10 a share.

which financial barons socialize the costs of private bets gone bad” (The New York Times 2008a) and then calling the same fears of moral hazard misguided shortly thereafter (Sorkin 2008c; The New York Times 2008b, 2008c). The criticisms of the two newspapers thus justified their critiques by diverging logics. The *WSJ* underscored the risk of creating precedence for federal involvement in the private marketplace, while the *NYT* proffered their criticism for the government’s defense of “Fat Cat” bankers (The New York Times 2008d). The discrepancy, between a conservative and liberal interpretation of the bailouts, would continue throughout the two newspapers’ coverages of the crisis.

By brokering the arrangement between J.P. Morgan and Bear Stearns, and further sweetening the deal by assuming the risk on Bear’s books, regulators assured that they would be held accountable for the outcome of the deal. Moreover, because of the conflation of regulator and administration action, the criticism targeted President George W. Bush as well (Solomon, Hagerty, and Ng 2008; Wessel 2008; Wall Street Journal 2008b; Myers 2008). The backlash fed upon the revelation that the government would be liable for more than \$28 billion should Bear’s assets prove rotten; however, the regulators anticipated this response while orchestrating the bailout and thus tried to thwart it by contacting relevant politicians to convince them that a bailout was necessary (Sorkin 2009, 33). Moreover, the Treasury set staffers to “carefully” checking morning newspapers in preparation of any criticism (Sorkin 2009, 69). Notwithstanding such preparations, the political condemnation of the Bear Stearns bailout was “one of the few completely bipartisan affairs in town” (Sorkin 2009, 38). Secretary of the Treasury Hank Paulson experienced the most vivid expression of this condemnation at a press conference, when he was confronted by a journalist quoting a *WSJ* article (Sidel et al. 2008) to ask whether the government just set a precedent for future systemic bailouts (Sorkin 2009, 33).

5.2 “It’s Time Mr. Paulson Put Taxpayers Ahead of Wall Street”

With Bear Stearns gone, the next banks facing insolvency were the two mortgage behemoths Fannie Mae and Freddie Mac, which together owned more than \$5.3 trillion worth of mortgages, despite being crucially undercapitalized (FCIC 2011, 309).¹⁷ Initially, the regulators did not want to bailout Fannie and

¹⁷ Fannie Mae and Freddie Mac were originally commissioned by the U.S. federal government to buy U.S.-American mortgages in order to encourage further mortgage creation. This gave the institutions a semi-public nature, with a supposed understanding that the government would guarantee their assets. This government sponsorship helps explain the discrepant viewpoints between the *WSJ* and the *NYT* towards their bailout.

Freddie directly, given the enormous cost of such an undertaking; instead, they attempted to calm the markets. To this end, in July 2008, Paulson appeared before the U.S. Congress to solicit a more encompassing financial and political authority. To make his case, he employed a metaphor that became quickly infamous, declaring: “If you’ve got a squirt-gun in your pocket you may have to take it out. If you’ve got a bazooka, and people know you’ve got it, you may not have to take it out” (Wall Street Journal 2008c). Paulson believed that an expanded authority would serve to tranquilize the markets by signaling that the U.S. government was willing to do whatever it took to stop the crisis. However, only six weeks after the Treasury was granted its “bazooka” via the Housing and Economic Recovery Act, it was employed to bail out Fannie and Freddie. This time though, without any contribution from private-sector banks, the bailout was effectively a government takeover, as the regulators placed Fannie and Freddie in conservatorship. In exchange, the U.S. government offered ample financial help to keep the banks afloat.

The decision to put Fannie and Freddie into conservatorship proved a tipping point, solidifying the critique that framed the regulators as accomplices to Wall Street chicanery. Increasingly, the Fed and the U.S. Treasury shared the lime-light with the Wall Street banks as subjects of blunt criticism, with Paulson and his bazooka the primary target. The *WSJ* declared that Paulson had forgotten the self-regulation principles that were supposed to be the foundation of the Bush administration (Jenkins 2008). Suggesting that the administration had lost control of its Fed officials, the *WSJ* employed its favored symbolic proxy, declaring, “It’s time Mr. Paulson put taxpayers ahead of Wall Street” (Wall Street Journal 2008d). The *NYT* largely supported bailing out Fannie and Freddie; however, this did not translate to unqualified backing for all bailout measures, especially when Paulson was portrayed as encouraging further debauchery on Wall Street (Morgenson 2008; Duhigg 2008b; The New York Times 2008e, 2008f). Alluding to the inauspiciousness of Paulson’s statement, the *NYT* mocked his “itchy finger” (Sorkin 2008b). In another July editorial, the *NYT* acknowledged “the evil of bailouts” and urged Congress to find alternatives that would punish reckless spending on Wall Street (The New York Times 2008g).

Reflecting the partisanship of an election year, these diverging critique narratives carried over to the rhetoric of the political actors, who echoed a liberal-conservative divide in their criticisms of the bailouts. Although in favor of the takeover of Fannie and Freddie as a means of providing federal oversight for the housing market, Democratic Senator Christopher Dodd castigated the administration and the Fed for rushing in to protect the investment bankers at Bear Stearns while keeping “individual homeowners” at risk (Hernandez 2008). Simultaneously, conservative politicians picked up on the criticisms of the *WSJ*, publicly expressing their disgust for these “un-American” measures. Republican Senator Jim Bunning was the most vocal, quipping after Fannie and Freddie were granted a new credit line in July 2008: “When I picked up my

newspaper yesterday, I thought I woke up in France. But no, it turned out it was socialism here in the United States of America” (Baum 2008).

5.3 “We’ll Protect Taxpayers from More Bailouts”

Press sentiment against further bailouts became more vocal as Lehman Brothers’ financial struggles made it an obvious candidate for the next bailout. The day before Lehman filed for bankruptcy on September 15, 2008, one *WSJ* editorial called for the Fed to abandon its “new de facto federal policy of underwriting Wall Street” and leave the company to its fate. Moreover, while pressing for Lehman to be punished and taxpayer dollars protected, the editorial portrayed the Fed as an accomplice of the incompetent and greedy Lehman Brothers executives (Wall Street Journal 2008e). In milder, yet not less critical terms, the *NYT* levelled charges of favoritism, stating that,

Lehman may not be too big to fail, but it may be too important to fail. Why? Because Richard S. Fuld Jr., Lehman’s chairman and chief executive, is too important. He is a member of an exclusive club: the board of directors of the Federal Reserve Bank of New York. (Sorkin 2008a)

Complicating matters was the timing of Lehman’s crisis only a few weeks before the national elections in November. While George W. Bush, having already served two terms, was not up for reelection, the constant coverage of the contest in newspapers enhanced the political pressure levied against the White House. The Democratic candidate, Senator Barack Obama, praised Paulson’s decision to bailout Fannie and Freddie, but promised that he would take “steps to ensure that management did not benefit at the expense of taxpayers” (Labaton 2008). More worrisome for the regulators were the statements coming from the Republican camp as Republican candidate Senator John McCain was consistently pressed about his plans to fix the financial situation and his opinion of the incumbent’s policies. Although maintaining a conservative aversion to financial regulation, McCain showed reluctance to directly criticize the approach of the Bush White House (Calmes 2008). However, as September approached, and the general election with it, the pressure mounted on McCain to distinguish himself from an increasingly embattled administration. In response, McCain and his running mate Sarah Palin published an editorial in the *WSJ* on September 9 with the provocative title “We’ll Protect Taxpayers from More Bailouts.” Primarily focused on the bailout of Fannie and Freddie, McCain and Palin promised that their administration would be different and called into question the regulatory policy of the regulators (McCain and Palin 2008). Their criticism adapted the rhetoric already present in conservative media sources, dwelling on the threats of moral hazard and the regulators’ disregard for American taxpayers and a neoliberal economic policy.

The accumulating pressure of the critique was evidently felt by the regulators, who widely acknowledged its constraint-setting character. President of the Federal Reserve bank Timothy Geithner remembered that “after Bear and Fannie and Freddie, Washington had become a cauldron of Old Testament populism and moral hazard fundamentalism” (Geithner 2014, 178). Paulson correspondingly admitted to this pressure by insisting that he could not be “Mr. Bailout” (Sorkin 2009, 284)¹⁸ and that there would be no government support for Lehman. What is more, he was reminded of his political responsibility to the Republican Party. During a Congressional hearing, Senator Bunning told him: “But come January, you will be gone, and the rest of us will be sitting at these tables [...] and we all have to be responsible to the taxpayer for what we have done” (Sorkin 2009, 202). Other officials shared this evaluation that further bailouts would cause irreparable damage to the regulators’ position. New York Fed Senior Vice President Patricia Mosser noted: “No more Maiden Lane [...] Moral hazard and reputation cost is too high” (FCIC 2011, 331). Another senior staffer of the Fed wrote to the public affairs division: “I just can’t stomach us bailing out Lehman... Will be horrible in the press don’t u think” (FCIC 2011, 330). Ben Bernanke, Chairman of the Fed, struck the same note, recalling that during the final week of Lehman Brothers “[o]ur challenge [...] went beyond finding a solution for Lehman. We would have to do so in the face of bitter criticism” (Bernanke 2015, 260f.).

The consequence of this increased critique was that the regulators shunned any display of support for Lehman Brothers, regardless of internal consensus about the grave consequences of the bank’s demise (cf. Bernanke 2010). Instead, they tried to orchestrate a private rescue for Lehman, in which a consortium of Wall Street banks – following the LTCM example – would buy its toxic assets, while the London-based bank Barclays would purchase the majority of Lehman Brothers. Yet, this arrangement fell apart when the U.S. regulators would not guarantee Lehman’s debts until Barclays’ board approved the deal (Valukas 2010; Sorkin 2009; FCIC 2011, 324ff.; Lowenstein 2010; Paulson 2013).¹⁹ Instead, on the morning of September 15, 2008, Lehman Brothers filed for bankruptcy. This time, the *NYT* insisted, Paulson had made “the right decision” (Reinhart 2008).

The *NYT*’s parting words to Lehman originated in its particular logic of critique, distinguished by its liberal views, as opposed to the conservative views in the *WSJ*. While neither political standpoint generated approval for bailouts in

¹⁸ Paulson was also warned by his staff about further bailouts: “Everyone is going to think, *Oh, Hank is coming with his checkbook*” (Sorkin 2009, 286f., emphasis in original).

¹⁹ It should be noted that, while there is no conclusive evidence to support this statement, the central banks seemed in general more willing to support Lehman Brothers than the Treasury was. The reason seems to be that the central banks involved in the events surrounding Lehman Brothers were politically independent (cf. Geithner 2014). However, this does not mean that they were not responsive to public pressure.

the media, they set different themes for their criticism (federal involvement, socialism vs. protection of banks). On the political side, though, the justification for criticizing followed a different logic by focusing mainly on the use of taxpayers' money to rescue banks. However, while we can also identify motives for resistance to bailouts – i.e. moral hazard concerns – that cut across the lines of political and media actors, the political critique – unlike the media critique – was steered by a high sensitivity of those aspects that immediately bore upon reelection chances.²⁰ In the next section, we turn to the effects of these different logics of critique with regard to the disaster threshold concept.

6. Discussion

Disaster thresholds present “decision rules” (Japp 1997, 302) that determine when disaster-avoiding action is taken. Initially, the disaster the regulators tried to avoid was the economic damage associated with the potential default of Bear Stearns and both Fannie and Freddie. Accordingly, these banks were bailed out. Yet, as we have reconstructed above, these bailouts generated considerable critique in public opinion – amongst media commentators, political opponents, and, probably most alarmingly for the sitting administration, members of their own party. It is important to note here that in the case of a one-time intervention, it is improbable that the ensuing critique reaches an intensity that changes the initial disaster threshold. However, the *repeated* interventions of 2008 and the political backlash they provoked shifted the regulators' disaster threshold, as the political consequences of a further bailout became itself the disaster to be avoided.²¹ The critical juncture in this regard was reached after the rescue of Fannie and Freddie. By then, the accumulated political risks effectively had turned the economic consequences of Lehman's default from a catastrophe to be absolutely avoided – after all, Lehman Brothers was decidedly larger than Bear Stearns – into an acceptable risk for the regulators. In other words, the political implications of a potential Lehman rescue now superimposed the economic consequences of its default. Thus, we argue that the non-rescue of Lehman Brothers was due to an *interventional dialectic* as every regulatory intervention in 2008 accumulated higher political risks that increased the pressure on the regulators to give political considerations precedence over their initial economic concerns. As a result, Lehman was let go.

²⁰ Theoretically, these divergent logics between media and political actors direct attention to an interesting link between the theory of differentiation (Luhmann 1982), which points to the divergent rationalities governing central societal systems such as politics and media, and the 'économie des conventions' emphasis on justification logics (Diaz-Bone 2015).

²¹ In this sense, the economic risk and the political risk are contradictory as they move on a continuum: avoiding the political disaster and the economic disaster at the same time is impossible. Thus, the necessity of a decision is imposed upon the regulators.

Our explanation stands in stark contrast to what the three main regulators claim. From their unanimous perspective, Lehman Brothers' assets were of such a marginal quality that they were legally not allowed to lend against it. In other words, Lehman was insolvent and, thus there was no legal authority to save it (Paulson 2013; Geithner 2014; Bernanke 2015).²² From this angle, the decision to let Lehman Brothers fail was no deliberate decision (Geithner 2014, 207). This claim, however, does not hold up to scrutiny, as both its order of events and sociological credibility are problematic. First, the influence of critique against further bailouts, a dynamic to which the regulators otherwise vividly attest, is excluded from their insolvency claim in favor of a purely mechanical explanation. This mechanical explanation then rests on the assumption that Lehman Brothers was objectively insolvent. However, recent investigations challenge this claim's validity. The *NYT* quotes a then-Fed official involved in Lehman's struggles that "[w]e had lawyers joined at our hips [...] but they never said we couldn't do it," and another that "[i]t was a policy and political decision, not a legal decision" (Stewart and Eavis 2014). The former CEO of Merrill Lynch, who took part in the Lehman negotiations, likewise said:

There was a tremendous amount of criticism of what was done with Bear Stearns [...]. It was a combination of political unwillingness [...] and a belief that there needed to be a reinforcement of moral hazard. There was never a discussion about the legal ability of the Fed to do this. (FCIC 2011, 341f.)²³

Moreover, according to the Financial Crisis Inquiry Commission, the regulators' legal justification of inaction first appeared only *after the fact* (FCIC 2011, 343). Although we do not want to theorize ahead of evidence, the need to justify the decision seems to stem from the postdecisional regret (Harrison and March 1984) on the side of the regulators generated by today's widely held opinion that Lehman's failure was a "fundamental error" (Sorkin 2009, 539).²⁴ Thus, it seems reasonable that their depictions of what happened are biased towards a view that presents their decisions as conditioned by the legal situation and thus out of their discretion.

What is more, our analysis begs the question whether the identified interventional dialectic presents a mechanism, that is a "recognizable causal pattern(s)" prone to repetition (Elster 1998, 45). To answer this, one must compare the events surrounding Lehman Brothers to similar settings or risk being plagued by the "small-N problem" (Mayntz 2004, 238), that is a lack of compa-

²² For a fierce vindication of this position as the "real" truth about Lehman Brothers, see: Grunwald 2014.

²³ Sorkin states that "it seems undeniable that a public outcry [...] was at least a factor in how he [Paulson] approached Lehman's dilemma" (Sorkin 2009, 539).

²⁴ The German magazine "Der Spiegel" states that, in New York, the bailout is viewed as "more stupid than the Bay of Pigs invasion and more serious than the Iraq war" (Brinkbäumer et al. 2009, 42, our translation).

rable cases in which regulators intervened in the markets *repeatedly at short intervals*. However, such an endeavor lies outside this article's reach. Nonetheless, two conditions must be taken into account in any potential comparison. First, the dominant role of a free-market ideology heightened the political significance of the interventions, making the U.S.-American setting vital to the disposition of subsequent responses. Furthermore, the temporal structure of the political system matters insofar as the political backlash experienced by the regulators was amplified by the upcoming presidential elections in November 2008. Thus, it remains an open question whether a significant distance to the next elections would have alleviated this effect. Both aspects set constraints due to the high specificity required for possible comparisons. Also due to this high specificity, it seems questionable whether Lehman Brothers marks a critical juncture for future regulatory decision making. Rather, it appears reasonable to assume that the specific circumstances that led to the absence of regulatory intervention in the case of Lehman Brothers will have no lasting impact on the premise that some institutions are eligible for government help in times of crisis. Moreover, the mergers that occurred during the subprime-crisis – either because regulators pressured ailing banks to find buyers or because healthy institutions took over their weakened competitors – led to the creation of even bigger financial institutions (cf. FCIC 2011, 386), whose potential to wreak havoc on the financial markets in case of their default probably has reinforced the resolve to intervene.

7. Conclusion

Many observers noted that it was the regulators' inconsistency in determining which banks were eligible for a bailout and which were not – showcased by the decision to let Lehman go – that became a major source of uncertainty and significantly exacerbated the crisis (Sorkin 2009, 539; FCIC 2011, 343). As a U.S.-economist noted: “The Lehman decision abruptly and surprisingly tore the perceived rule book into pieces and tossed it out the window” (Stewart and Eavis 2014). Consequently, following Lehman's demise, banks increased their efforts to prop up their positions by freezing what little lending activity remained. One predominant aspect of Lehman's legacy thus lies not in the immediate economic consequences of its default, but in the subsequent *social change brought about by the disruption of the expectation that the U.S. government would predictably save all those institutions considered too-big-to-fail*. However, this is *not* to say that the regulators stopped all rescue missions after Lehman Brothers. Quite the contrary, the economic consequences of Lehman's insolvency were so dire that the Bush administration had few other

choices than to rescue all those too-big-to-fail institutions that followed Lehman Brothers.²⁵ Figuratively speaking, after the economic consequences of Lehman's bankruptcy, the regulators disaster threshold "snapped back," once again giving the economic risk of further defaults precedence over the political risk associated with these bailouts. However, this was not so much due to an inconsistent approach by the regulators as a direct reaction to the situation created by Lehman's default.

In this article, we highlighted by means of an analysis informed by the sociology of risk, the crucial, yet so far neglected, role of social dynamics for the development of the financial crisis of 2007. We did so by analyzing the impact of the increasing critique of the bailout decisions of 2008 on the decision to let Lehman go. The significant social change this decision brought about firmly attests to the importance of a sociological approach to financial crises that emphasizes these dynamics as a challenge to the dominant economic explanations.

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²⁵ After Lehman Brothers, Ben Bernanke was asked what would happen if the Fed did not take countervailing measures against the disruptions in the market. He famously responded that "there will be no economy on Monday" (Duke 2009).

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