THE FED AND LEHMAN BROTHERS

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During the 2008 financial crisis, the Fed rescued financial institutions such as Bear Stearns and AIG from bankruptcy.

Lehman Brothers filed for bankruptcy on September 15. Why didn't the Fed rescue Lehman?

This question matters because Lehman's failure greatly worsened the financial crisis and the Great Recession that followed. The effects on the economy are still felt today.

Popular explanations for the non-rescue:

- Political opposition to “bailouts” of big banks.
- Some institution had to fail to build support for rescuing others.
- A rescue would encourage risky behavior in the future (“moral hazard”).
- Policymakers underestimated the damage that Lehman’s bankruptcy would cause.

The explanation of Fed officials: They lacked the legal authority to lend Lehman the money it needed to survive.

Under Section 13(3) of the Federal Reserve Act, the Fed can lend to an investment bank only if the bank posts “satisfactory” collateral. (The Fed’s Legal Counsel: “You have to be pretty confident you will be repaid.”)

Ben Bernanke, 2009: “The company’s available collateral fell well short of the amount needed to secure a Federal Reserve loan of sufficient size to meet its funding needs. As the Federal Reserve cannot make an unsecured loan... the firm’s failure was, unfortunately, unavoidable.”

Ben Bernanke, 2010: “The only way we could have saved Lehman would have been by breaking the law, and I’m not sure I’m willing to accept those consequences for the Federal Reserve and for our system of laws.”

Bernanke said essentially the same thing in his 2015 memoir and in several interviews this year.

My research seeks to determine why the Fed did not rescue Lehman. The principal conclusion is that the explanation given by Fed officials is incorrect, in two senses:

(1) A perceived lack of legal authority was not the reason that officials chose not to rescue Lehman.

(2) A rescue would, in fact, have been legal, because Lehman had ample collateral for the loan it needed. The Fed could have prevented the firm's disorderly bankruptcy with negligible risk.

Much of the evidence for these conclusions comes from the investigations of the Financial Crisis Inquiry Commission (fcic.law.stanford.edu) and of Anton Valukas, the Lehman Bankruptcy Examiner (jenner.com/lehman). Both had subpoena power, interviewed hundreds of people, and gathered numerous documents and emails from Fed officials and Lehman executives.

Outline

1. A brief history of the crisis.
2. The feasibility of a Fed rescue.
3. Fed actions to ensure bankruptcy.
4. Real-time evidence on the reasons for the Fed’s actions.
5. Retrospective statements by Fed officials.

The Crisis of 2008

At the start of the year, the “Big Five” investment banks were Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers, and Bear Stearns. All five faced threats to their survival, for similar reasons:

- Large investments in real estate, which produced losses as the housing bubble collapsed.

- Low levels of capital relative to assets (high “leverage”). As a result, losses led markets to fear that the banks were becoming insolvent.

- Heavy reliance on short-term borrowing. Fears of insolvency caused lenders to cut off funding–a 21st century version of a bank run.

Chronology

March

Run on Bear Stearns. Bear rescued through acquisition by JPMorgan Chase, after Fed creates Maiden Lane LLC to purchase $30 billion of Bear's risky assets.

Fed creates Primary Dealer Credit Facility (PDCF) to lend to other investment banks facing runs.

September

Sept 7: Government takes over Fannie Mae and Freddie Mac.

Sept 10-12: Run on Lehman.

Saturday Sept 13: Tentative deal for the British bank Barclays to acquire Lehman.

Sunday Sept 14: Barclays deal is held up by objections from the U.K.'s Financial Services Authority.

Sunday Sept 14: Merrill Lynch acquired by Bank of America.

Monday Sept 15, 1:45 AM: Lehman files bankruptcy petition.

Tuesday Sept 16: Fed lends $85 billion to AIG.

September-December

A credit crunch: banks cut lending and corporations find it expensive or impossible to issue bonds.

Stock prices plummet.

Foreclosures on home mortgages.

Record lows in consumer confidence.

Economy enters a deep recession, unemployment rises rapidly.

Goldman Sachs and Morgan Stanley survive. They borrow $69 billion and $107 billion respectively from the PDCF and other Fed facilities.

The Feasibility of a Lehman Rescue

My calculations:

Lehman needed a loan of approximately $84 billion to remain in operation.

It had ample collateral: at least $114 billion of available assets that were acceptable at the PDCF.

Why this makes sense:

Lehman needed cash primarily to offset losses of repurchase agreements ("repos"). Repos are collateralized loans. When private lenders stopped accepting Lehman's collateral, the firm could have pledged it to the PDCF instead.

Fed Actions to Ensure Bankruptcy

On September 14, Fed officials instructed Lehman to file for bankruptcy. They then took actions to ensure that the firm had no good alternative.

A complex story...

The entity that filed the famous bankruptcy petition was Lehman Brothers Holdings Inc. (LBHI), a corporation with many subsidiaries.

Most of the subsidiaries also entered bankruptcy on September 15, but one did not: Lehman's New York broker-dealer, Lehman Brothers Inc. (LBI). LBI stayed in operation by borrowing $28 billion from the PDCF, and most of it was acquired by Barclays on September 18.

Another subsidiary that needed cash was Lehman's London broker-dealer, Lehman Brothers Inc. Europe (LBIE). The Fed did not allow LBIE to borrow from the PDCF, or allow LBI to borrow and transfer cash to LBIE.

LBIE defaulted on debts due on September 15. Many of these debts were guaranteed by LBHI, so it also defaulted.

(On September 21, the PDCF started lending to the London broker-dealers of Goldman Sachs and Morgan Stanley.)

An adequate Fed loan ($84 billion rather than $28 billion) could have averted the abrupt bankruptcy on September 15 and supported Lehman for weeks or months. That would have bought time to resolve Lehman's crisis with less disruption to the financial system and economy.

Possible outcomes:

Completion of the Barclays deal.

Restructuring of Lehman to maintain it as an independent firm.

An orderly wind down.

<u>Policymakers' Discussions During the Crisis</u>

Extensive discussion of possible lending to Lehman, documented by the FCIC. Little discussion about the adequacy of Lehman's collateral, and none of the Fed's legal authority.

Officials were worried about political backlash from a Lehman rescue. An email from Treasury Secretary Paulson's chief of staff to his press secretary:

> I just can't stomach us bailing out Lehman. Will be horrible in the press, don't u think?

The decision about Lehman was made primarily by Secretary Paulson, even though he had no legal authority in the matter.

Neither Paulson nor Fed officials fully anticipated the damage from the bankruptcy (see transcript of September 16 meeting of the Federal Open Market Committee).

Policymakers' Statements Since the Bankruptcy

Officials have repeatedly asserted that Lehman lacked adequate collateral for a loan. But when pressed to support this claim, they are non-responsive or make flawed arguments.

An example of non-responsiveness:

FCIC follow-up letter after testimony by Ben Bernanke (2010):

During your testimony, you stated that the Federal Reserve Bank of New York conducted a collateral analysis of Lehman Brothers, upon which you relied to make your decision not to use the Federal Reserve's Section 13(3) authority. Please provide the collateral analysis, the name of the person who communicated the collateral analysis to you, and the time and location when you were informed of the collateral analysis. Please inform the Commission of the name or names of persons who conducted the collateral analysis for the Federal Reserve Bank of New York. In addition, please provide a list of persons with whom you or your staff consulted with regards to this matter in the White House or the Treasury and any related memoranda, documents, emails, etc.

Bernanke's reply:

This information was conveyed to me by phone that weekend by FRBNY officials.

An example of a flawed argument:

In arguing that a rescue was impossible, officials assert that Lehman was insolvent. But they confuse the concepts of insolvency and illiquidity.

From the FCIC testimony of Thomas Baxter, Legal Counsel for the Federal Reserve Bank of New York:

Commissioner Wallison: Mr. Fuld [Lehman CEO] has said Lehman was solvent; and I haven't heard anyone actually contradict that yet.

Witness Baxter: Commissioner Wallison, one definition of "insolvent" is failure to pay your debts as they come due. And that was the situation that Lehman was experiencing at the end of Lehman week. And it couldn't pay its debts as they came due. No one would extend credit to it.

NOTE: Under the law, the Fed can lend to an investment bank *only* if it "is unable to secure adequate credit accommodations from other banking institutions."

Another Example of a Flawed Argument

Both Bernanke and Baxter misinterpret the minutes of Lehman's board meeting on September 14.

In arguing that it was futile to assist Lehman, Bernanke and Baxter quote statements that "it was likely the Corporation would ultimately have to file for protection under Chapter 11" and that bankruptcy was an "ultimate inevitability."

It is clear from the minutes that Lehman's executives and lawyers believed bankruptcy was inevitable *because the Fed refused to assist the firm*. It does not make sense to cite that belief as a reason not to offer assistance.