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Failed Lehman Rescue efforts: Myths, Facts, and Lessons

By Yusuke Horiguchi

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Yusuke Horiguchi is a Japanese Economist with a PhD from Rice University in the US. He was selected as the First Deputy Managing Director and Chief Economist of the Institute of International Finance in 2003. Before this his career was based at the International Monetary Fund, where his roles included Director of the Asia-Pacific Department. In 2010 Yusuke stepped down from the IIF, but continues to follow current issues in Finance and Economics at his own interest.

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Introduction

Did Lehman really have to fail? This is one of the least-attended but most critical issues of the first decade and a half of this century. My view is that Lehman could have been saved. The US authorities had the wherewithal to do so within their legal authority, contrary to the claims made by former Treasury Secretary Paulson and former Fed Chairman Bernanke. It is also my view, based on a standard economic reasoning, that Lehman should have been saved, given that Lehman's final days were unfolding in the midst of a deepening systemic financial crisis that seemed ready to unleash a tidal wave of contagion in the event of a major shock. Needless to say, it would not have been for the sake of Lehman but for the sake of safeguarding the financial system.

Why the US authorities' Lehman rescue efforts failed and what could have been done for a successful result are the main subjects of this article. It should be made clear at the outset that a successful Lehman rescue alone would not have shielded the US economy against a great recession like the one in 2008-9. In addition to a successful Lehman rescue, such an outcome would have required many, if not all, of the policy actions actually taken in the aftermath of Lehman's collapse. Some, or even many, would likely argue that, in the absence of Lehman's collapse and its unprecedented aftermath, it would have been politically impossible for the authorities to take the kinds of actions they actually took. Maybe so. But the lesson for the future is clear. All-out efforts in a consistent manner are what it takes to prevent a systemic financial crisis of considerable severity from morphing into a catastrophic one with an attendant macroeconomic calamity. Even a single misguided policy step, such as what the September 2008 Lehman rescue efforts exemplify, could inflict a huge damage to the whole crisis management strategy.

Economic rationale for an official bailout in a systemic financial crisis.

In a systemic financial crisis, strong forces of contagion--a virulent form of negative externality--put even the solidest financial firms with no faults of their own at serious risk, because of other firms' plight. Essentially, investors and depositors run, trying to liquidate claims on any firms that are perceived to be situated even remotely similarly to firms in actual trouble. This is a notorious example of market failure, providing a justification for public intervention, aimed at preventing the financial system's collapse, typically involving taxpayer money. This is a standard economic analysis, widely accepted, at least at this level of generality, and with a straightforward prescription on the general direction of policy to be followed when coping with severe system-wide financial stresses. It needs emphasis, however, that the prescription is applicable only to systemic crisis situations.

There is no question that the situation the US financial system faced in early days of September 2008 was that of a serious systemic crisis. Not only that. The crisis was gaining its ferocity at an alarming speed, with its dynamics so unpredictable as to leave little clue about where the next shoe would fall. By the time of the fateful weekend of September 13-14, the situation had evolved into one that was none other than the epitome of "unusual and exigent circumstances", in which the Fed was authorized to exercise extraordinary lending power under Section 13-3 of the Federal Reserve Act (in particular pre Dodd-Frank). Justification for decisive public interventions, with the Fed playing a critical role using its Section 13-3 power, could not have been stronger. Not bailing out a big financial firm in trouble in such a situation could cost taxpayers much more dearly than the direct cost of bailout, as witnessed in the wake of Lehman's collapse, an event which should have been prevented.

An obvious culprit for the failure of Lehman rescue efforts.

Why did the frantic efforts to rescue Lehman led by Secretary Paulson during the climactic weekend at the NY Fed fail? It does not take a rocket scientist to figure out that a posture of no public money for a Lehman rescue, adhered doggedly by Paulson throughout that weekend, made an already very difficult task of preventing Lehman's collapse an almost impossible one, as documented amply in Ross Sorkin's Too Big To Fail, and former Treasury Secretary Geithner's Stress Test. To be sure, the political appetite for the use of taxpayer money for rescuing large financial firms, if ever existed, seemed all but evaporated, especially following the bailouts of Fannie and Freddie several days earlier. That, however, does not make the posture of no public money for a Lehman rescue, in the midst of a violent systemic financial crisis, any less inappropriate. As pointed out in those books, had Paulson chosen to indicate, at a strategic moment, his potential readiness to be less inflexible, at the end of the day, perhaps contingent on certain conditions, the process and the outcome of rescue efforts could well have been different.

Prior to his departure for the NY Fed late afternoon of Friday September 12, Secretary Paulson had been given then President Bush's approval to wind down Lehman without using federal resources, along with an instruction that, if government resources were needed, the secretary would have to come back to the president. Against that backdrop, Paulson's plan was to tap resources necessary to rescue Lehman from a consortium of major private financial firms, along the lines of what was done for LTCM a decade earlier. What is not clear is why Paulson did not go back to the president when it became obvious, by sometime in the afternoon of Sunday, September 14, that the resources committed by the consortium, alone, would not do the job. He might have concluded that Lehman could not be saved even with public money. Or he might have considered the time left to be too short to persuade the president and then make an effective use of public resources.

One plausible explanation for Secretary Paulson not going back to the president for the use of public resources is an analytical assessment circulating at the Treasury and the Fed that financial firms were ready to cope with a Lehman failure given their intense preparation over the six months since the Bear Stearns event. This judgment was receiving considerable top level supports at those institutions, as clearly indicated, for example, by remarks made by Chairman Bernanke before Senate Committee on banking, Housing, and Urban Affairs on September 23, 2008. However, the analytical premise of this judgment was a cavalier one, to say the least, ignoring altogether a fallacy of composition typical in a panic whereby individual firms' rational behavior to run from risks collectively acts almost like a death sentence for the financial system already on its knees. The extent to which Secretary Paulson was convinced by this analytical assessment is not known. However, in light of the closest working relationship between Paulson, Bernanke, and Geithner during the crisis, it would be surprising if this assessment did not influence Paulson's decision not to go back to the president, who likely would have been very difficult to persuade given the intense anti-bailout sentiment of his own, and the equally intense sentiment of the public he had to contend with.

Legal authority issue: what is the crux of the matter?

Strangely, post Lehman's bankruptcy, Secretary Paulson's public statements on why Lehman was not bailed out by the US authorities cast aside the policy of no public money for a Lehman rescue which he so resolutely stuck to during that momentous weekend. Paulson instead contended, like chairman Bernanke, that, given the lack of adequate collateral on the part of Lehman, they had no legal authority to lend to Lehman, even under Section 13-3, an amount sufficient for it to weather the storm and survive. Aside from a question, perhaps somewhat rhetorical, of why Paulson had to be so vehemently opposed to something that, according to him, they were not even legally authorized to do, a set of "circumstantial evidences" points to rather shaky grounds on which this contention stood.

To begin with, contrary to their public statements, the real legal authority issue in Lehman's case was not whether the Fed had legal authority to lend to Lehman under Section 13-3 but rather whether the Fed had legal authority to proffer a guarantee for Lehman's trading obligations during the interim between the time of Barclays (a UK bank, the only potential buyer of Lehman in the final stage) and Lehman signing an acquisition agreement and the time of the deal's closure. On Sunday September 14, with a consortium of major banks having already agreed, to meet Barclays' demand, to put up $33 billion to fund a special vehicle to purchase Lehman's toxic assets--a la Maiden Lane the NY Fed created for Bear Stearns rescue--the last hurdle blocking Barclays top executives' signing of an agreement in New York that day to acquire Lehman was the absence of a Barclays shareholders' yes vote on proffering trading obligations guarantee.

With the UK authorities refusing then to waive the country's requirement of a shareholders' vote on this, the only way viewed as potentially available for the merger deal to get signed that day was for the Fed, instead of Barclays, to proffer such a guarantee to Lehman, until the time of Barclays shareholders' yes vote. And that was what was deemed legally impossible for the Fed to do, as articulated by NY Fed general counsel Baxter in his statement to the Financial Crisis Inquiry Commission. So, Paulson and Bernanke were right in claiming that they did not have legal authority, but the legal authority in question was not one related to lending to Lehman in the alleged absence of adequate collateral but one related to proffering a temporary guarantee for Lehman's trading obligations. This distinction is critical. The Fed's lack of legal authority in this very specific and narrow matter cannot be considered as the last word on a broader issue of whether a legal way to use public money to rescue Lehman could not have been found.

A key issue in that broader context is whether Lehman had adequate collateral for a Fed loan under Section 13-3. The assertion of Paulson and Bernanke notwithstanding, a strong support for a positive answer to this question is found in the bank consortium's unambiguous decision to provide $33 billion to fund a special vehicle to buy Lehman's toxic assets. According to the Sorkin's book, the way the consortium valued those assets for deciding how much to provide was merciless, with 25-50% writedowns from Lehman's own downbeat estimates being common across those assets. A reliable basis for assessing the suitability of those assets as collateral for the Fed's potential loan operation for a Lehman rescue is found in NY Fed lending for Bear Stearns rescue. In that bailout, the collateral for the NY Fed's $29 billion loan to Maiden Lane was valued using, as is, Bear Stearns marks as of March 14. It would be a mystery if the Fed indeed had no legal authority to lend for a Lehman rescue based on the far more stringently valued collateral.

Legal ways could have been found

These considerations indicate that a way could have been found to get around the aforementioned specific legal obstacle and let Barclays sign the purchase deal. For example, given the consortium's commitment to provide $33 billion, a plausible scenario for Lehman rescue would have been for the consortium, instead of the Fed, to proffer the needed guarantee, using that money as a means to boost the guarantee's credibility, and for the Fed in tandem to fund a special vehicle to purchase Lehman's toxic assets, as it did for Bear Stearns. Would the consortium have demanded that the guarantee be secured by collateral? Not likely, in the light of the total lack of any "fusses" on the part of JP Morgan Chase in proffering the required guarantee to Bear Stearns, in sharp contrast to its adamant refusal to proceed with the acquisition deal in the absence of the Fed's commitment in effect to covering the great bulk of possible losses associated with Bear's toxic assets. Had the consortium asked for collateral, it very likely would have found adequate collateral among Lehman's non-toxic assets valued then at more than $500 billion.

As a final point on the legal issues, it should be emphasized that the Fed's lack of legal authority to proffer a guarantee as such should not have been taken as precluding a search for an instrument available within the Fed's legal power that performs a function equivalent to a straightforward guarantee for Lehman's trading obligations. To leave no room for doubt that Lehman's commitment in trade deals be honored, all that the Fed would have had to do was to make a non-recourse loan to Lehman in the amount of any trading transaction that

Lehman did not have resources to consummate, taking the assets acquired from the counterparty to the deal as primary collateral. The Fed had the authority to make such a loan (and could have prevented a bankruptcy) but did not use it. Another possible channel through which to provide public financial support for a Lehman rescue was thus left unexplored.

"It is the UK authorities that killed the rescue effort" is wide off the mark.

The absence of official financial support to underpin the Lehman rescue plan being developed in New York made the UK authorities highly sceptical of the plan's workability, causing them to refuse to go along with the US authorities' prodding to give Barclays the green light for its acquisition of Lehman. The sketch provided by Paulson of the deal in the works, notable for no official skin in the game, clearly indicated to the UK authorities that Barclays would be taking on more risk than it could manage. What they looked for, in order to be supportive, was an assurance that the deal was sufficiently watertight to cope with any worst-case scenario. In the UK authorities' view, such assurance was possible, in the midst of the raging systemic crisis, only with an unequivocal financial backing of the US authorities for the deal. While the UK authorities' strong disinclination to go along, including its refusal to waive the requirement of a shareholders' vote on proffering of the guarantee, was taken by the US side as the final nail into the coffin of the deal, it should have been crystal clear from the very outset that there was absolutely no way for the UK government-or any other government for that matter-to endorse the deal as envisaged, in effect bankrolling a US investment bank when the US authorities would not.

Moral hazard nonsense.

An analysis of why Lehman rescue efforts failed would be amiss if it did not discuss a possible role played by a concern about the moral hazard affecting big financial firms. Despite its powerful influence in politics, substantively moral hazard affecting such firms is merely an untested extrapolation of a concept relevant for individuals' behavior to organizations'. To begin with, an official bailout of such firms is for the system's stability and never for any individual stakeholder. In cases where a firm on the brink gets bought into a healthier firm, it loses its own identity, and its stakeholders typically lose big time. Even in the bailouts of AIG and Citi in which their identities were preserved, the losses incurred by their shareholders as well as top executives and highly paid staff, typically with substantial holdings of shares of their respective companies, were enormous. Given that, an idea that individual stakeholders behave recklessly just because of the knowledge that their firm would be bailed out in time of crisis is absurd. So, then, is the notion of the moral hazard affecting large financial firms.

Moral hazard was not a driver of large financial firms' pre-crisis reckless behavior; greed and other basic frailties of many key individual stakeholders were. Despite its little substance, the concern about moral hazard has intensified in the aftermath of the repeated bailouts of unprecedented scales. This is visible in certain recent regulatory changes, including in particular Dodd-Frank's elimination of the Fed's power to lend to individual nonbanks and of the broader FDIC guarantee authority. Making the collapse of systemic firms during a crisis less preventable while lessening the authorities' ability to keep the panic from spreading can prove a devastating combination. In contrast to significant regulatory reform achieved on crisis prevention side, retrogression is the clear trend for the crisis management apparatus charged with the imperative of preserving systemic stability, driven by moral hazard concern and anti-bailout sentiment. Last time, the authorities failed to make full use of available instruments; next time of a category-5 hurricane, they will find themselves short of instruments. This has to change without delay.

Real costs of official bailouts to the economy

The above view on moral hazard should not be taken as implying that bailing out a significant financial firm in a systemic crisis entails no costs to the economy. It does. Contrary to a popularly-held perception, however, costs to the economy have little to do with the financial burden imposed on taxpayers who collectively foot the bill for government bailout of a failing big bank. In fact, an official bailout of a big bank, which represents a transfer of financial resources from one party in the private sector (taxpayers) to another (a big bank) effected by the government, imposes no direct economic burden on the private sector as a whole. That is because the direct burden occurs only when the government takes away real resource from the private sector by its own spending on goods and services. The economic burden of an official bailout on the private sector (and the whole economy) arises in a less direct, and hardly noticed way, namely in the form of what is called the excess burden associated with households' and businesses' adjustments to relative price changes occasioned by higher taxes. An additional cost to the economy results from the (continued) use of scarce resources by an inefficient firm that could be utilized better by an efficient firm needing no bailout.

Neither of those economic costs of a bailout is conspicuous. However, neither of those costs is insignificant, and each of them adds up cumulatively if systemic crises and bailouts in such crises get repeated over time. The economy's longer term growth prospects, as well as the basic grain of the market economy, get compromised. This is another reason why it is important for policy makers to minimize the risk of recurrence of a systemic financial crisis. It is also vital that policy makers allow themselves a recourse to an official bailout of a significant financial firm only as an action of last resort. Still, it needs emphasis that, should a systemic financial crisis recur in the future for whatever reasons, with a clear and present danger of wide-spread contagions, bailing out big financial firms is likely to entail less economic costs than sticking to a policy of no official bailout or adhering to an approach of using no taxpayer money in an official rescue attempt. This is a key lesson to be drawn from the Lehman episode.