Letting Lehman Fail Was A Choice, And It Was The Right One

Mark Calabria

October 3, 2014

Perhaps the most dangerous myth to come out of financial crisis is that if we had just rescued Lehman Brothers everything would have been fine. Behind this myth is the Dodd-Frank (empty) promise of more regulatory tools.

Further embedding the regulatory bias toward bailouts is worse. Obsessions over Lehman have distracted us from correcting the actual imbalances in our system that caused the crisis. Letting Lehman fail was the right choice. The problem was not applying this to other insolvent firms.

Earlier this week the *New York Times* ran a story claiming that insiders at the New York Federal Reserve had actually concluded that the Fed did have the authority to rescue Lehman. The implication of the story seems to be that not doing so was a tragic mistake.

These "revelations" really aren't all that surprising or even relevant. Depending on the day of the week and who you ask, one gets a variety of explanations for why Lehman was not rescued; lack of legal authority, lack of liquidity assets, and so on. Since when did regulators let a lack of legal authority stop them? There was zero legal authority for the FDIC's broad guarantee of bank holding debt. That didn't seem to matter. Thanks to some enterprising reporters at *Bloomberg*, who dared to sue the Fed, we now know the Fed lends against all sorts of shoddy assets, including equity. So let's get one thing clear: saving Lehman would have been just one of many actions of questionable legality taken by regulators. Hank Paulson admits as much in his crisis memoirs, *On The Brink.*

Let us first recall that by the time of Lehman's failure we were already in a recession. The American economy had already lost almost 2 million jobs the cycle before Lehman's failure. The overwhelming majority of the decline in real consumer spending occurred before Lehman's failure. In all likelihood most of the job losses after Lehman were due to declines in real consumer spending that preceded Lehman's failure. Unless Lehman's failure created some Star Trek-style backward ripple in time, the temporal order is quite clear: we were already in a deep recession by the time of Lehman's failure. Saving Lehman would not have changed that.

Contra conventional wisdom, the Lehman bankruptcy was not all that disorderly. Most of Lehman's operations changed hands within weeks. Barclays quickly acquired Lehman's American operations, while Nomura purchased Lehman's European, Middle Eastern and African operations. While countless transactions are still being resolved within Lehman's bankruptcy proceedings, the fact is that the bulk of Lehman cleanly and quickly changed hands in an orderly manner. Compared to the resolutions of AIG, Fannie Mae or the auto companies, which all received billions of taxpayer dollars, the Lehman resolution was a smashing success.

The bankruptcy of Lehman also allowed its assets to transfer in a more efficient manner than the shotgun marriages arranged by the Fed. JP Morgan Chase has recently paid billions in fines and compliance costs due to its assisted purchase of Bear Stearns. Bank of America was for some time paralyzed by its acquisition of Countrywide, spending billions on litigation, compliance and mitigation of Countrywide's legacy mortgage portfolio. Those deals might have looked smart at the time, but they hobbled their acquirers in a manner that reduced lending relative to purchasing such assets out of bankruptcy. Typical of financial crisis responses, they placed short-term appearances before long-term sustainability.

Lehman's failure also served as the rationale for a massive expansion of federal power under Dodd-Frank. By claiming that regulators "lack the tools" both Congress and the regulators could ignore their own failings and find solace in expanding the power of regulators to "resolve" nonbanks. But even when regulators had the power to resolve nonbanks at no cost to the taxpayers, as with Fannie Mae and Freddie Mac, regulators choose not to use those tools. There's no reason we should expect regulators to behave any differently in the future.

Ultimately the responses to the financial crisis were not about avoiding losses but deciding who would bear them. In too many cases the decision was made to have the taxpayer bear those losses (or other members of the financial industry). Lehman's failure was a last minute attempt to insert market discipline and allow losses to be borne by private parties. This changed the market expectations created by Bear's rescue. We know that Lehman leadership repeatedly refused offers to be purchased, unwilling to accept any offers below $10 per share because "that's what Bear got." Had the correct decision been made on Bear, Lehman would likely have been purchased and its failure averted. Even so, we have no hope of avoiding future crises unless we bring market discipline back to our financial markets. Allowing Lehman to fail was the right choice. The mistake was not applying that choice to other insolvent companies.

Mark Calabria is Director of Financial Regulation Studies at the Cato Institute.