Appendix 8.3

Bernanke's Fed and the Lehman Bankruptcy

On Monday, September 15, 2008, Lehman Brothers Holdings, Inc. filed for bankruptcy. The S&P 500 had dropped 20.0% from its October 9, 2007 record high through the previous Friday close. It was a garden-variety bear market up to that point. It turned into a great crash after Lehman failed, with the S&P 500 plunging another 46.0% through the bear market's bottom on March 9, 2009. Previously, Bear Stearns and Merrill Lynch had been on the brink of failing, causing the Fed to arrange bailouts—with JP Morgan acquiring the former firm and Bank of America acquiring the latter one. The question is: Why didn't the Fed avert the collapse of Lehman, which arguably worsened the financial crisis of 2008 significantly? It was the only large financial institution that was allowed to fail.

Then-Fed Chairman Ben Bernanke and other Fed officials maintained that the Fed lacked legal authority. In his opening remarks on August 21, 2009 at the Fed's annual Jackson Hole gathering, he explained:

> The case of the investment bank Lehman Brothers proved exceptionally difficult, however. Concerted government attempts to find a buyer for the company or to develop an industry solution proved unavailing, and 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, and as the government as a whole lacked appropriate resolution authority or the ability to inject capital, the firm's failure was, unfortunately, unavoidable. The Federal Reserve and the Treasury were compelled to focus instead on mitigating the fallout from the failure, for example, by taking measures to stabilize the triparty repurchase (repo) market.[1]

The *Financial Crisis Inquiry Commission Report* (2011) states: "Fed Vice Chairman Donald Kohn told Bernanke that in the wake of Bear's collapse, some institutional investors believed it was a matter not of whether Lehman would fail, but when."[2]

The report strongly implies that the federal government should have intervened to save Lehman:

> Federal government officials decided not to rescue Lehman for a variety of reasons, including the lack of a private firm willing and able to acquire it, uncertainty about Lehman's potential losses, concerns about moral hazard and political reaction, and erroneous assumptions that Lehman's failure would have a manageable impact on the financial system because market participants had anticipated it. After the fact, they justified their decision by stating that the Federal Reserve did not have legal authority to rescue Lehman. The inconsistency of federal government decisions in not rescuing Lehman after having rescued Bear Stearns and the GSEs, and immediately before rescuing AIG, added to uncertainty and panic in the financial markets.[3]

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[1] "Opening Remarks: Reflections on a Year of Crisis,," Bernanke's August 21, 2009 speech.
[2] The Financial Crisis Inquiry Commission's January 2011 *The Financial Crisis Inquiry Report,* as updated February 25, 2011. p. 325.
[3] FCIC *report*, p. 343.

Professor Laurence Ball provides a revisionist history of what happened in a July 2016 paper "The Fed and Lehman Brothers."[1] His goal in writing the paper was "to set the record straight." He concludes that "the explanation offered by Fed officials is incorrect, in two senses: a perceived lack of legal authority was not the reason for the Fed's inaction; and the Fed did in fact have the authority to rescue Lehman." He summarizes his findings as follows:

- There is a substantial record of policymakers' deliberations before the bankruptcy, and it contains no evidence that they examined the adequacy of Lehman's collateral, or that legal barriers deterred them from assisting the firm.

- Arguments about legal authority made by policymakers since the bankruptcy are unpersuasive. These arguments involve flawed interpretations of economic and legal concepts, and factual claims that do not appear to be accurate.

- From a *de novo* examination of Lehman's finances, it is clear that the firm had ample collateral for a loan to meet its liquidity needs. Such a loan could have prevented a disorderly bankruptcy, with negligible risk to the Fed.

- More specifically, Lehman probably could have survived by borrowing from the Fed's Primary Dealer Credit Facility on the terms offered to other investment banks. Fed officials prevented this outcome by restricting Lehman's access to the PDCF.

In his book *Tectonic Shifts in Financial Markets* (2016), Henry Kaufman discusses the bankruptcy of Lehman.[2] He was on the firm's board of directors at the time of Lehman's collapse. He wrote that Bernanke's record on handling the 2008 crisis was "decidedly mixed." Bernanke didn't see it coming and he was "slow to respond," according to Kaufman. He concludes, "The decision by key government officials to let Lehman fail was heavily influenced by politics." Still, Kaufman acknowledges that Lehman placed the government in the position of bailing out a private firm "that had placed massive and, as it turned out massively risky bets." As one of Lehman's directors, he says he opposed bankruptcy because he believed "that if we kept the doors open, government officials would be compelled to come" to the firm's rescue.

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[1] Ball's paper *The Fed and Lehman Brothers*, July 2016.
[2] See Kaufman's *Tectonic shifts in Financial Markets* (2016), pp. 41-48.
Source: Yardeni Research, Inc.