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Lehman Brothers Bankruptcy and the Financial Crisis: Lessons Learned

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September 15 marks the fifth anniversary of the Lehman Brothers bankruptcy, the supposed spark that set off the financial crisis of 2008. Conventional wisdom holds that it was the federal government's decision *against* bailing out this investment bank that froze credit markets and sent the economy into the "great recession."[1] In reality, though, while the Lehman bankruptcy sent a clear signal to investors of trouble in the marketplace, it was far from the cause of the crisis.

The key policy failure was likely regulators' decision the preceding March in *favor* of bailing out Bear Stearns, a (smaller) competing investment bank, rather than the decision not to save Lehman. The Bear Stearns bailout set the expectation that Lehman would also be bailed out, setting up investors and creditors for a fall. At the very least, those with a stake in Lehman surely expected the government to minimize their losses. Thus, the inconsistent treatment of the two investment banks—not simply the act of letting Lehman file bankruptcy—was the main problem.

Arbitrary Decisions. Economists have long recognized that an inability to predict future government actions can lead people to (at best) delay their decision making. People will most likely wait to buy housing, for instance, if they are unsure what flood insurance rates the government will announce in a few months.

In the case of Lehman and Bear Stearns, two of the nation's largest investment banks, inconsistent government policy heightened uncertainty in the financial markets. On March 24, 2008, the Federal Reserve announced it would provide (through the New York Fed) special financing to "facilitate" JPMorgan Chase's acquisition of the financially troubled Bear Stearns. In other words, the U.S. government bailed out the investment bank Bear Stearns, allowing shareholders to avoid a total loss.

Naturally, the managers, creditors, shareholders, and potential buyers of Lehman Brothers (a much larger investment bank) expected similar treatment. When both Barclays and Bank of America were unable to secure similar protection against losses, they withdrew their bids.[2] Lehman filed for bankruptcy the next day—September 15, 2008.

It would have been inconsistent, but at least coherent, if the decision to let Lehman fail indicated that the federal government was not going to rescue any additional financial institutions. Instead, on September 16, the Federal Reserve announced it would lend (again through the New York Fed) up to $85 billion to the American International Group (AIG), an insurance company.[3]

The AIG bailout is often blamed on "contagion" from the Lehman bankruptcy, but AIG was financially troubled well before the Fed bailed it out. Lehman's collapse, of course, did affect AIG but only because it raised real questions about the worth of AIG's assets. The problem with AIG and Lehman (as

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well as other firms) was that they made highly leveraged bets on assets tied to worthless mortgages. Those assets lost value not because of the Lehman bankruptcy but because the default rates on the mortgages soared. Lehman was only the messenger, not the cause, of the bad news.[4]

The bailouts only multiplied after that. Within days of the AIG bailout, Treasury Secretary Hank Paulson was requesting an eye-popping $700 billion to bail out other institutions. The legislation regarding this request eventually became known as the Troubled Asset Relief Program (TARP).

Trouble Already in the Economy. Aside from the turmoil caused by the incoherent policy of the federal government, there are several other reasons that point to the Lehman bankruptcy as just one of the symptoms, rather than a cause, of the financial crisis:

- By the first quarter of 2007, defaults on subprime mortgages had risen to a four-year high.[5] These mortgages, along with the mortgage-backed securities that were tied to them, represent the "toxic assets" that the TARP program was originally designed to get rid of.
- By the last quarter of 2007, almost exactly one year prior to the Lehman collapse, both personal consumption expenditures and civilian employment for the U.S. began downward trends.
- The difference between key interest rates spiked during the last half of 2007. The rise in these "spreads"—a commonly used measure of perceived risk—indicates that market participants saw trouble in 2007. Aside from the widely reported issues in the interbank lending markets (a short-term lending market used by banks), the spread between three-month commercial paper rates (a short-term lending market used by all sorts of people) and U.S. Treasury rates also widened in August of 2007.
- The Federal Housing Finance Agency placed Fannie Mae and Freddie Mac in government conservatorship on September 7, 2008—one week before the Lehman bankruptcy filing.

There is little doubt that the Federal Reserve noticed the dangers well before Lehman Brothers failed. The record shows that the Federal Reserve lowered its interest rate target for the federal funds rate (another key short-term lending market for banks) from 5.25 percent in September 2007 to 3 percent in January 2008.[6] Such an aggressive move by the Fed is highly unusual and occurs only when the Fed fears an economic downturn. The signs of fundamental trouble in the economy were clear, and they would not go away regardless of a Lehman bailout.

A Dangerous Myth. The notion that allowing Lehman to file bankruptcy caused the financial crisis is both wrong and dangerous. The danger in this myth is that it perpetuates the policy of bailing out financial institutions with taxpayer money—and that it allows policymakers who caused the crisis to escape responsibility for their actions.

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1. See Al Lewis, "Fraud, Failure and Bankruptcy Pay Well for CEOs," Market Watch, August 28, 2013, http://www.marketwatch.com/story/fraud-failure-and-bankruptcy-pay-well-for-ceos-2013-08-28 (accessed September 12, 2013).
2. Josh Fineman and Yalman Onaran, "Lehman Brothers' Corporate History and Chronology: Timeline," Bloomberg, September 15, 2008, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a63mWc3ILITo (accessed September 12, 2013).
3. AIG ultimately received another $100 million from the U.S. Treasury. See Edmund Andrews and Peter Baker, "A.I.G. Planning Huge Bonuses After $170 Billion Bailout," *The New York Times*, March 14, 2009, http://www.nytimes.com/2009/03/15/business/15AIG.html (accessed September 12, 2013).
4. Five years later, the evidence for such contagion (or interconnectedness) remains somewhat sparse. See Charles Calomiris, "Comment on 'Interconnectedness and Contagion," American Enterprise Institute, February 8, 2013, http://www.aei.org/files/2013/02/07/-charles-calomiris-powerpoint_181340717207.pdf (accessed September 12, 2013); and Hal Scott, "Interconnectedness and Contagion," American Enterprise Institute, November 20, 2012, p. 290, http://www.aei.org/files/2013/01/08/-interconnectedness-and-contagion-by-hal-scott_153927406281.pdf (accessed September 12, 2013).
5. Sharon L. Crenson and Kathleen M. Howley, "U.S. Subprime Mortgage Delinquencies at 4-Year High (Update3)," Bloomberg, March 13, 2007, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=abn2OMGGvJCM (accessed September 12, 2013).
6. See the Federal Reserve Bank of St. Louis, "The Financial Crisis: A Timeline of Events and Policy Actions," http://timeline.stlouisfed.org/index.cfm?p=timeline (accessed September 12, 2013).