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SEPTEMBER 2008: THE BANKRUPTCY OF LEHMAN

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Solvency should be a simple financial concept: if your assets are worth more than your liabilities, you are solvent; if not, you are in danger of bankruptcy. But on the afternoon of Friday, September 12, 2008, experts from the country’s biggest commercial and investment banks met at the Wall Street offices of the Federal Reserve to ponder the fate of Lehman Brothers, and could not agree whether or not the 157-year-old firm was solvent.

Only two days earlier, Lehman had reported shareholder equity—the measure of solvency—of \$28 billion at the end of August. Over the previous nine months, the bank had lost \$6 billion but raised more than \$10 billion in new capital, leaving it with more reported equity than it had a year earlier.

But this arithmetic reassured hardly anyone outside the investment bank. Fed officials had been discussing Lehman’s solvency for months, and the stakes were very high. To resolve the question, the Fed would not rely on Lehman’s \$28 billion figure, given questions about whether Lehman was reporting assets at market value. As one New York Fed official wrote to colleagues in July, “Balance-sheet capital isn’t too relevant if you’re suffering a massive run.”¹ If there is a run, and a firm can only get fire-sale prices for assets, even large amounts of capital can disappear almost overnight.

The bankers thought Lehman’s real estate assets were overvalued. In light of

Lehman's unreliable valuation methods, the bankers had good reason for their doubts. None of the bankers at the New York Fed that weekend believed the \$54 billion in real estate assets (excluding real estate held for sale) on Lehman's books was an accurate figure. If the assets were worth only half that amount (a likely scenario, given market conditions), then Lehman's \$28 billion in equity would be gone. In a fire sale, some might sell for even less than half their stated value.

"What does solvent mean?" JP Morgan CEO Jamie Dimon responded when the FCIC asked if Lehman had been solvent. "The answer is, I don't know. I still could not answer that question."² JP Morgan's Chief Risk Officer Barry Zubrow testified before the FCIC that "from a pure accounting standpoint, it was solvent," although "it obviously was financing its assets on a very leveraged basis with a lot of short-term financing."³

Testifying before the FCIC, former Lehman Brothers CEO Richard Fuld insisted his firm had been solvent: "There was no capital hole at Lehman Brothers. At the end of Lehman's third quarter, we had \$28.4 billion of equity capital."⁴ Fed Chairman Ben Bernanke disagreed: "I believe it had a capital hole." He emphasized that New York Federal Reserve Bank President Timothy Geithner, Treasury Secretary Henry Paulson, and SEC Chairman Christopher Cox agreed it was "just way too big a hole. And my own view is it's very likely that the company was insolvent, even, not just illiquid."⁵ Others, such as Bank of America CEO Ken Lewis, who that week considered acquiring Lehman with government support, had no doubts either. He told the FCIC that Lehman's real estate and other assets had been overvalued by \$60 to \$70 billion—a message he had delivered to Paulson a few days before Lehman declared bankruptcy.⁶

It had been quite a week; it would be quite a weekend. The debate will continue over the largest bankruptcy in American history, but nothing will change the basic facts: a consortium of banks would fail to agree on a rescue, two last-minute deals would fall through, and the government would decide not to rescue this investment bank—for financial reasons, for political reasons, for practical reasons, for philosophical reasons, and because, as Bernanke told the FCIC, if the government had lent money, "the firm would fail, and not only would we be unsuccessful but we would have saddled the taxpayer with tens of billions of dollars of losses."⁷

"GET MORE CONSERVATIVELY FUNDED"

After the demise of Bear Stearns in March 2008, most observers—including Bernanke, Paulson, Geithner, and Cox⁸—viewed Lehman Brothers as the next big worry among the four remaining large investment banks. Geithner said he was "consumed" with finding a way that Lehman might "get more conservatively funded."⁹ 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*.¹⁰ One set of numbers in particular reinforced their doubts: on March 18, the day after JP Morgan announced its acquisition of Bear Stearns, the market

(through credit default swaps on Lehman's debt) put the cost of insuring \$10 million of Lehman's five-year senior debt at \$310,000 annually; for Merrill Lynch, the cost was \$241,000; and for Goldman Sachs, \$165,000.

The chief concerns were Lehman's real estate-related investments and its reliance on short-term funding sources, including \$7.8 billion of commercial paper and \$197 billion of repos at the end of the first quarter of 2008. There were also concerns about the firm's more than 900,000 derivative contracts with a myriad of counterparties.¹¹

As they did for all investment banks, the Fed and SEC asked: Did Lehman have enough capital—real capital, after possible asset write-downs? And did it have sufficient liquidity—cash—to withstand the kind of run that had taken down Bear Stearns? Solvency and liquidity were essential and related. If money market funds, hedge funds, and investment banks believed Lehman's assets were worth less than Lehman's valuations, they would withdraw funds, demand more collateral, and curtail lending. That could force Lehman to sell its assets at fire-sale prices, wiping out capital and liquidity virtually overnight. Bear proved it could happen.

"The SEC traditionally took the view that liquidity was paramount in large securities firms, but the Fed, as a consequence of its banking mandate, had more of an emphasis on capital raising," Erik Sirri, head of the SEC's Division of Trading and Markets, told the FCIC. "Because the Fed had become the de facto primary regulator because of its balance sheet, its view prevailed. The SEC wanted to be collaborative, and so came to accept the Fed's focus on capital. However, as time progressed, both saw the importance of liquidity with respect to the problems at the large investment banks."¹²

In fact, both problems had to be resolved. Bear's demise had precipitated Lehman's "first real financing difficulties" since the liquidity crisis began in 2007, Lehman Treasurer Paolo Tonucci told the FCIC.¹³ Over the two weeks following Bear's collapse, Lehman borrowed from the Fed's new lending facility, the Primary Dealer Credit Facility (PDCF),¹⁴ but had to be careful to avoid seeming overreliant on the PDCF for cash, which would signal funding problems.

Lehman built up its liquidity to \$45 billion at the end of May, but it and Merrill performed the worst among the four investment banks in the regulators' liquidity stress tests in the spring and summer of 2008.

Meanwhile, the company was also working to improve its capital position. First, it reduced real estate exposures (again, excluding real estate held for sale) from \$90 billion to \$71 billion at the end of May and to \$54 billion at the end of the summer. Second, it raised new capital and longer-term debt—a total of \$15.5 billion of preferred stock and senior and subordinated debt from April through June 2008.

Treasury Undersecretary Robert Steel praised Lehman's efforts, publicly stating that it was "addressing the issues."¹⁵ But other difficulties loomed. Fuld would later describe Lehman's main problem as one of market confidence, and he suggested that the company's image was damaged by investors taking "naked short" positions (short selling Lehman's securities without first borrowing them), hoping Lehman would fail, and potentially even helping it fail by eroding confidence. "Bear went down on rumors and a liquidity crisis of confidence," Fuld told the FCIC. "Immediately there-

after, the rumors and the naked short sellers came after us.”¹⁶ The company pressed the SEC to clamp down on the naked short selling.¹⁷ The SEC’s Division of Risk, Strategy and Financial Innovation shared with the FCIC a study it did concerning short selling. As Chairman Mary Schapiro explained to the Commission, “We do not have information at this time that manipulative short selling was the cause of the collapse of Bear and Lehman or of the difficulties faced by other investment banks during the fall of 2008.” The SEC to date has not brought short selling charges related to the failure of these investment banks.¹⁸

On March 18, Lehman reported better-than-expected earnings of \$489 million for the first quarter of 2008. Its stock jumped nearly 50%, to \$46.49. But investors and analysts quickly raised questions, especially concerning the reported value of Lehman’s real estate assets. Portfolio.com called Lehman’s write-downs “suspiciously minuscule.”¹⁹ In a speech in May, David Einhorn of Greenlight Capital, which was then shorting Lehman’s stock, noted the bank’s large portfolio of commercial real estate loans and said, “There is good reason to question Lehman’s fair value calculations. . . . I suspect that greater transparency on these valuations would not inspire market confidence.”²⁰

Nell Minow, editor and co-founder of the Corporate Library, which researches and rates firms on corporate governance, raised other reasons that observers might have been skeptical of management at Lehman. “On Lehman Brothers’ [board], . . . they had an actress, a theatrical producer, and an admiral, and not one person who understood financial derivatives.”²¹ The Corporate Library gave Lehman a D rating in June 2004, a grade it downgraded to F in September 2008.²² On June 9, Lehman announced a preliminary \$2.8 billion loss for its second quarter—the first loss since it became a public company in 1994. The share price fell to \$30. Three days later Lehman announced it was replacing Chief Operating Officer Joseph Gregory and Chief Financial Officer Erin Callan. The stock slumped again, to \$22.70.

“THIS IS NOT SOUNDING GOOD AT ALL”

After Lehman reported its final second-quarter results on June 12, the New York Fed’s on-site monitor at Lehman, Kirsten Harlow, reported that there had been “no adverse information on liquidity, novations, terminations or ability to fund either secured or unsecured [funds].”²³ The announced liquidity numbers were better that quarter, as were the capital numbers.

Nevertheless, Lehman’s lenders and supervisors were worried. The next morning, William Dudley, then head of the New York Fed’s Markets Group (and its current president), emailed Bernanke, Geithner, Kohn, and others that the PDCF should be extended because it “remains critical to the stability” of some of the investment banks—particularly Lehman. “I think without the PDCF, Lehman might have experienced a full blown liquidity crisis,” he wrote.²⁴

Just one week after the earnings release, Harlow reported that Lehman was indeed having funding difficulties. Four financial institutions had “trading issues” with Lehman and had reduced their exposure to the firm, including Natixis, a

French investment bank that had already eliminated all activity with Lehman. JP Morgan reported that large pension funds and some smaller Asian central banks were reducing their exposures to Lehman, as well as to Merrill Lynch. And Citigroup requested a \$3 to \$5 billion “comfort deposit” to cover its exposure to Lehman, settling later for \$2 billion.²⁵ In an internal memo, Thomas Fontana, the head of risk management in Citigroup’s global financial institutions group, wrote that “loss of confidence [in Lehman] is huge at the moment.”²⁶ Timothy Clark, senior adviser in the Federal Reserve’s banking supervision and regulation division, was short and direct: “This is not sounding good at all.”²⁷

On June 25, results from the regulators’ most recent stress test showed that Lehman would need \$15 billion more than the \$54 billion in its liquidity pool to survive a loss of all unsecured borrowings and varying amounts of secured borrowings.²⁸ Lehman’s borrowings in the overnight commercial paper market were increasing, however, from \$3 billion at the end of November 2007 to \$8 billion at the end of May 2008. And it was reliant on repo funding, particularly the portions that matured overnight and were collateralized by illiquid assets.²⁹ As of mid-June, 62% of Lehman’s liquidity was dependent on borrowing against nontraditional securities, such as illiquid mortgage-related securities—which could not be financed with the PDCF and of which investors were becoming increasingly wary.³⁰

On July 10, Federated Investors—a large money market fund and one of Lehman’s largest tri-party repo lenders—notified JP Morgan, Lehman’s clearing bank, that Federated would “no longer pursue additional business with Lehman,” because JP Morgan was “unwilling to negotiate in good faith” and had “become increasingly uncooperative” on repo terms.³¹ Dreyfus, another large money market fund and a Lehman tri-party repo lender, also pulled its repo line from the firm.³²

“SPOOK THE MARKET”

As the Fed considered the risks of the tri-party repo market, it also mulled over more specific measures to help Lehman. The New York Fed and FDIC both rejected the company’s proposal to convert to a bank holding company, a proposal which Geithner told Fuld was “gimmicky” and “[could not] solve a liquidity/capital problem.”³³ A proposal by the Fed’s Dudley followed the Bear Stearns model: \$60 billion of Lehman’s assets would be held by a new special-purpose vehicle, financed by \$5 billion of Lehman’s equity and a \$55 billion loan from the Fed. This proposal would remove the illiquid assets from the market and potentially avert a fire sale that could render Lehman insolvent.³⁴ It didn’t go anywhere.

But when that idea was floated in July, the need for such action was still somewhat speculative. Not so by August. In an August 8 email to colleagues at the Federal Reserve and Treasury, Patrick Parkinson, then the deputy director of the Federal Reserve Board’s Division of Research and Statistics, described a “game plan” that would (1) identify activities of Lehman that could significantly harm financial markets and the economy if it filed for chapter 11 bankruptcy protection, (2) gather information

to more accurately assess the potential effects of its failure, and (3) identify risk mitigation actions for areas of serious potential harm.³⁵

As they now realized, regulators did not know nearly enough about over-the-counter derivatives activities at Lehman and other investment banks, which were major OTC derivatives dealers. Investment banks disclosed the total number of OTC derivative contracts they had, the total exposures of the contracts, and their estimated market value, but they did not publicly report the terms of the contracts or the counterparties. Thus, there was no way to know who would be owed how much and when payments would have to be made—information that would be critically important to analyze the possible impact of a Lehman bankruptcy on derivatives counterparties and the financial markets.

Parkinson reviewed a standing recommendation to form a “default management group” of senior executives of major market participants to work with regulators to anticipate issues if a major counterparty should default. The recommendation was from the private-sector Counterparty Risk Management Policy Group, the same group that had alerted the Fed to the backlog problem in the OTC derivatives market earlier in the decade. Parkinson suggested accelerating the formation of this group while being careful not to signal concerns about any one market participant.³⁶ On August 15, Parkinson emailed New York Fed officials that he was worried that no sensible game plan could be formulated without more information.³⁷ He was informed that New York Fed officials had just met with Lehman two days earlier to obtain derivative-related information, that they still needed more information, and that the meeting had “caused a stir,” which in turn required assurances that requests for information would not be limited to Lehman.³⁸

New York Fed officials were also “very reluctant” to request copies of the master agreements that would shed light on the Lehman’s derivatives counterparties, because such a request would send a “huge negative signal.”³⁹ The formation of the industry group seemed “less provocative,” wrote a New York Fed official, but could still “spook the market.”⁴⁰ Parkinson believed that the information was important, but attempting to collect it was “not without risks.”⁴¹ He also recognized the difficulties in unraveling the complex dependencies among the many Lehman subsidiaries and their counterparties, which would keep lawyers and accountants busy for a long time.⁴²

On August 28, Treasury’s Steve Shafran informed Parkinson that Secretary Paulson agreed on the need to collect information on OTC derivatives.⁴³ It just had to be done in a way that minimized disruptions. On September 5, Parkinson circulated a draft letter requesting the information from Lehman CEO Fuld.⁴⁴ Geithner would ask E. Gerald Corrigan, the Goldman Sachs executive and former New York Fed president who had co-chaired the Counterparty Risk Management Policy Group report, to form an industry group to advise on information needed from a troubled investment bank. Parkinson, Shafran, and others would also create a “playbook” for an investment bank failure at Secretary Paulson’s request. Events over the following week would render these efforts moot.

On September 4, executives from Lehman Brothers apprised executives at JP Morgan, Lehman's tri-party repo clearing bank, of the third-quarter results that it would announce two weeks later. A \$3.9 billion loss would reflect "significant asset write-downs." The firm was also considering several steps to bolster capital, including an investment by Korea Development Bank or others, the sale of Lehman's investment management division (Neuberger Berman), the sale of real estate assets, and the division of the company into a "good bank" and "bad bank" with private equity sponsors.⁴⁵ The executives also discussed JP Morgan's concerns about Lehman's repo collateral.

On Monday, September 8, more than 20 New York Fed officials were notified of a meeting the next morning "to continue the discussion of near-term options for dealing with a failing nonbank." They received a list documenting Lehman's tri-party repo exposure at roughly \$200 billion. Before its collapse, Bear Stearns's exposure had been only \$50 to \$80 billion. The documentation further noted that 10 counterparties provided 80% of Lehman's repo financing, and that intraday liquidity provided by Lehman's clearing banks could become a problem. Indeed, JP Morgan, Citigroup, and Bank of America had all demanded more collateral from Lehman, with the threat they might "cut off Lehman if they don't receive it."⁴⁶

On Tuesday morning, September 9, news there would be no investment from Korea Development Bank shook the market. Lehman's stock plunged 55% from the day before, closing at \$7.79. To prepare for an afternoon call with Bernanke, Geithner directed his staff to "put together a quick 'what's different? what's the same?' list about [Lehman] vs [Bear Stearns], as well as about mid-March (then) vs. early Sept (now)."⁴⁷ The Fed's Parkinson emailed Treasury's Shafran about his concerns that Lehman would announce further losses the next week, that it might not be able to raise equity, and that even though its liquidity position was better than Bear Stearns' had been, Lehman remained vulnerable to a loss of confidence.⁴⁸

At 5:00 P.M., Paulson convened a call with Cox, Geithner, Bernanke, and Treasury staff "to deal with a possible Lehman bankruptcy."⁴⁹ At 5:20 P.M., Treasury Chief of Staff Jim Wilkinson emailed Michelle Davis, the assistant secretary for public affairs at Treasury, to express his distaste for government assistance: "We need to talk. . . . I just can't stomach us bailing out lehman. . . . Will be horrible in the press don't u think?"⁵⁰

That same day, Fuld agreed to post an additional \$3.6 billion of collateral to JP Morgan. Lehman's bankruptcy estate would later claim that Lehman did so because of JP Morgan's improper threat to withhold repo funding. Zubrow said JP Morgan requested the collateral because of its growing exposure as a derivatives trading counterparty to Lehman.⁵¹ Steven Black, JP Morgan's president, said he requested \$5 billion from Lehman, which agreed to post \$3.6 billion.⁵² He did not believe the request put undue pressure on Lehman. On Tuesday night, executives of Lehman and JP Morgan met again at Lehman's request to discuss options for raising capital. The JP Morgan group was not impressed. "[Lehman] sent the Junior Varsity," JP Morgan executives reported to Black. "They have no proposal and are looking to us for ideas/credit line to bridge them to the first quarter when they intend to split into good bank/bad bank." Black responded, "Let's give them an order for the same drugs

they have apparently been taking to think we would do something like that.”⁵³ The Lehman bankruptcy estate has a different view. It alleges Black agreed to send a due diligence team, following Dimon’s suggestion that his firm might be willing to purchase Lehman preferred stock, but instead sent over senior risk managers to probe Lehman’s confidential records and plans.⁵⁴

The bankruptcy estate alleges that later that night, JP Morgan demanded that Lehman execute amended agreements to its tri-party repo services before preannouncing its third-quarter earnings at 7:30 the next morning. The amendments required Lehman to provide additional guarantees, increased Lehman’s potential liability, and gave JP Morgan additional control over Lehman bank accounts.⁵⁵ Again, the Lehman bankruptcy estate argues that Lehman executed the agreements because JP Morgan executives led Lehman to believe its bank would refuse to extend intraday credit if Lehman did not do so. JP Morgan denies this. Black told the FCIC, “JPMC never told Lehman that it would stop extending credit and clearing if the September Agreements were not executed before the markets opened on [Wednesday,] September 10, 2008.”⁵⁶

Before the market opened on Wednesday, Lehman announced its \$3.9 billion third-quarter loss, including a \$5.6 billion write-down. Four hours later, Matthew Rutherford, an adviser to Treasury, emailed colleagues that several large money funds had reduced their exposure to Lehman, although there was not yet “a wholesale pull back of [repo] lines.”⁵⁷

“Importantly, Fidelity, the largest fund complex, stressed that while they hadn’t made any significant shifts yet today, they were still in the process of making decisions and wanted to update me later in the day,” Rutherford wrote. By Friday, Fidelity would have reduced its tri-party repo lending to Lehman to less than \$2 billion from over \$12 billion the previous Friday; according to Fidelity’s response to an FCIC survey of market participants, in the week prior to Bear’s demise in March, Fidelity had pulled its entire \$9.6 billion repo line to that company.

“IMAGINATION HAT”

At the Federal Reserve, working groups were directed to “spend the next few hours fleshing out how a Fed-assisted BofA acquisition transaction might look, how a private consortium of preferred equity investors transaction might look, and how a Fed takeout of tri-party repo lenders would look.”⁵⁸ That day, New York Fed Senior Vice President Patricia Mosser circulated her opinion on Dudley’s request for “thoughts on how to resolve Lehman.” She laid out three options: (1) find a buyer at any price, (2) wind down Lehman’s affairs, or (3) force it into bankruptcy. Regarding option 1, Mosser said it “should be done in a way that requires minimal temporary support. . . . No more Maiden Lane LLCs and no equity position by [the] Fed. Moral hazard and reputation cost is too high. If the Fed agrees to another equity investment, it signals that everything [the Fed] did in March in terms of temporary liquidity backstops is useless. Horrible precedent; in the long run MUCH worse than option 3.” Option 3, bankruptcy, would be “[a] mess on every level, but fixes the moral hazard problem.”⁵⁹

On Wednesday night, a New York Fed official circulated a “Liquidation Consortium” game plan to colleagues.⁶⁰ The plan was to convene in one room senior-level representatives of Lehman’s counterparties in the tri-party repo, credit default swap, and over-the-counter derivatives markets—everyone who would suffer most if Lehman failed—and have them explore joint funding mechanisms to avert a failure. According to the proposed game plan, Secretary Paulson would tell the participants they had until the opening of business in Asia the following Monday morning (Sunday night, New York time) to devise a credible plan. The game plan stated that “we should have in mind a maximum number of how much we are willing to finance before the meeting starts, but not divulge our willingness to do so to the consortium.”⁶¹ Indeed, Paulson would tell the consortium when it met two days later that the government was willing to let Lehman fail.⁶²

Former Bank of America CEO Ken Lewis told the FCIC that Treasury Secretary Paulson had called him on Wednesday, September 10, and asked him to take another look at acquiring Lehman, assuring him that Fuld was ready to deal. Paulson and Geithner had arranged for Fuld and Lewis to discuss an acquisition in July, but Fuld had not been interested in selling the entire firm at that time. Because of this history, Lewis expressed his concerns to Paulson that Fuld would not want to sell the entire company or would not be willing to sell at a realistic price. Still, a team of Bank of America executives began reviewing Lehman’s books, and on the next day, Fuld sounded optimistic about a deal. But Bank of America determined that Lehman’s assets were overvalued, and Lewis told Paulson there would be no deal without government assistance. Undeterred, Paulson told Lewis—as Lewis informed the FCIC—to put on his “imagination hat” and figure out a deal. His insistence kept the Bank of America executives working, but on Friday, September 12, Lewis called Paulson to repeat his assessment—no government support, no deal. Apparently Fuld had been kept out of the loop, and began to call Lewis at home. Lewis’s wife told Fuld that Lewis would not come to the phone and to stop calling.⁶³

On Thursday September 11, an email time-stamped 8:26 A.M. from Susan McCabe, a Goldman Sachs executive, to Dudley and others set the tone for the day: “It is not pretty, This is getting pretty scary and ugly again. . . . They [Lehman] have much bigger counter-party risk than Bear did, especially in Derivatives market, so [t]he market is getting very spooked, nervous. Also have Aig, Wamu concerns. This is just spinning out of control again. Just fyi, this is shaping up as going to be a rough day.”⁶⁴ Bernanke was informed that if Lehman failed, “it would be a much more complex proposition to unwind their positions than it would have been to unwind the positions held by Bear Stearns,” because Lehman was “nearly twice the size of Bear Stearns.”⁶⁵

Some believed government action was required. At 10:46 A.M., Hayley Boesky, a senior New York Fed official, forwarded to her colleagues an email from the hedge fund manager Louis Bacon suggesting the New York Fed could “attempt to stabilize or support the LEH situation” but noting that “none of the above will fix the fundamental problem, which is too many bad assets that need to get off too many balance sheets.”⁶⁶

At 1:40 P.M., Fed officials circulated the outline of a plan to create a “Lehman Default Management Group,” a group of Lehman counterparties and creditors who would make plans to cope with a Lehman bankruptcy. They would agree to hold off on fully exercising their rights to close out their trades with Lehman; instead, they would establish a process to “net down”—that is, reduce—all exposures using a common valuation method.⁶⁷ A little before midnight on Thursday, Boesky notified colleagues that panicked hedge funds had called to say they were “expecting [a] full blown recession” and that there was a “full expectation that Leh goes, wamu and then ML [Merrill Lynch].” They were “ALL begging, pleading for a large scale solution which spans beyond just LEH.” Boesky compared the level of panic to the failure of Bear Stearns—“On a scale of 1 to 10, where 10 is Bear-Stearns-week-panic, I would put sentiment today at a 12.”⁶⁸

At almost the same time, JP Morgan demanded that Lehman post another \$5 billion in cash “by the opening of business tomorrow in New York”; if it didn’t, JP Morgan would “exercise our right to decline to extend credit to you.”⁶⁹ JP Morgan CEO Dimon, President Black, and CRO Zubrow had first made the demand in a phone call earlier that evening to Lehman CEO Fuld, CFO Ian Lowitt, and Treasurer Paolo Tonucci.⁷⁰ Tonucci told the JP Morgan executives on the call that Lehman could not meet the demand. Dimon said Lehman’s difficulties in coming up with the money were not JP Morgan’s problem, Tonucci told the FCIC. “They just wanted the cash. We made the point that it’s too much cash to mobilize. There was no give on that. Again, they said ‘that’s not our problem, we just want the cash.’”⁷¹ When Tonucci asked what would keep JP Morgan from asking for \$10 billion tomorrow, Dimon replied, “Nothing, maybe we will.”⁷²

Under normal circumstances, Tonucci would not have tolerated this treatment, but circumstances were far from normal. “JPM as ‘clearing bank’ continues to ask for more cash collateral. If we don’t provide the cash, they refuse to clear, we fail,” was the message circulated in an email to Lehman executives on Friday, September 12. So Lehman “delivered the \$5 billion in cash only by pulling virtually every unencumbered asset it could deliver.”⁷³

JP Morgan’s Zubrow saw it differently. He told the FCIC that the previously posted \$3.6 billion of collateral by Lehman was “inappropriate” because it was “illiquid” and “could not be reasonably valued.” Moreover, Zubrow said the potential collateral shortfall was greater than \$5 billion.⁷⁴ Lehman’s former CEO, Fuld, told the FCIC that he agreed to post the \$5 billion because JP Morgan said it would be returned to Lehman at the close of business the following day.⁷⁵ The Lehman bankruptcy estate made the same allegation. This dispute is now the subject of litigation; the Lehman bankruptcy estate is suing JP Morgan to retrieve the \$5 billion—and the original \$3.6 billion.⁷⁶

“HEADS OF FAMILY”

Should Lehman be allowed to go bankrupt? Within the government, sentiments varied. On Friday morning, as Secretary Paulson headed to New York to “sort through

this Lehman mess,” Wilkinson wrote that he still “[couldn’t] imagine a scenario where we put in [government] money . . . we shall see.”⁷⁷ That afternoon, Fed Governor Warsh wrote, in response to a colleague’s hope the Fed would not have to protect some of Lehman’s debt holders, “I hope we don[’]t protect anything!”⁷⁸ But on Friday, Fed Chairman Bernanke was taking no chances. He stayed behind in Washington, in case he had to convene the Fed’s board to exercise its emergency lending powers.⁷⁹

Early Friday evening, Treasury Secretary Paulson summoned the “heads of family”—the phrase used by Harvey Miller, Lehman’s bankruptcy counsel, to describe the CEOs of the big Wall Street firms⁸⁰—to the New York Fed’s headquarters. Paulson told them that a private-sector solution was the only option to prevent a Lehman bankruptcy. The people in the room needed to come up with a realistic set of options to help limit damage to the system. A sudden and disorderly wind-down could harm the capital markets and pose the significant risk of a precipitous drop in asset prices, resulting in collateral calls and reduced liquidity: that is, systemic risk. He could not offer the prospect of containing the damage if the executives were unable to fashion an orderly resolution of the situation, as had been done in 1998 for Long-Term Capital Management. Paulson did offer the Fed’s help through regulatory approvals and access to lending facilities, but emphasized that the Fed would not provide “any form of extraordinary credit support.”⁸¹ As New York Fed General Counsel Tom Baxter told the FCIC, Paulson made it clear there would be no government assistance, “not a penny.”⁸²

H. Rodgin Cohen, a veteran Wall Street lawyer who has represented most of the major banks, including Lehman, told the FCIC that the government’s “not a penny” posture was a calculated strategy: “I don’t know exactly what the government was thinking, but my impression was they were playing a game of chicken or poker or whatever. It was said on more than one occasion that it would be very politically difficult to rescue Lehman. There had been a lot of blowback after Bear Stearns. I believe the government thought that it could, with respect to a game of chicken, persuade the private sector to take a big chunk” of Lehman’s liabilities.⁸³

The Fed’s internal liquidation consortium game plan would seem to confirm Cohen’s view, given that it contemplated a financial commitment, even though that was not to be divulged.⁸⁴ Moreover, notwithstanding Paulson’s “not a penny” statement, the United Kingdom’s chancellor of the exchequer, Alistair Darling, said that Paulson told him that “the FRBNY might be prepared to provide Barclays with regulatory assistance to support a transaction if it was required.”⁸⁵

At that consortium meeting on Friday night, Citigroup CEO Vikram Pandit asked if the group was also going to talk about AIG. Timothy Geithner said simply: “Let’s focus on Lehman.”⁸⁶

“TELL THOSE SONS OF BITCHES TO UNWIND”

What would happen if JP Morgan refused to provide intraday credit for Lehman in the tri-party repo market on Monday, September 15? The Fed had been considering this possibility since the summer. As Parkinson noted, the fundamental problem was that even if Lehman filed for bankruptcy, the SEC would want Lehman’s broker-

dealer to live on and would not want the Fed in its position as lender to grab tri-party collateral.⁸⁷ Parkinson told the FCIC staff that Zubrow informed him over the weekend that JP Morgan would not unwind Lehman's repos on Monday if the Fed did not expand the types of collateral that could be financed through the PDCF lending facility. Earlier in the year, Parkinson had said that JP Morgan's refusal to unwind would be unforgivable. Now he told Geithner to "tell those sons of bitches . . . to unwind."⁸⁸

Merrill CEO John Thain told the FCIC that by Saturday morning, the group of executives reviewing Lehman's assets had estimated that they were overvalued by anywhere from \$15 to \$25 billion. Thain thought that was more than the assembled executives would be willing to finance and, therefore, Thain believed Lehman would fail.⁸⁹ If Lehman failed, Thain believed, Merrill would be next. So he had called Ken Lewis, the CEO of Bank of America, and they met later that day at Bank of America's New York corporate apartment. By Sunday, the two agreed that Bank of America would acquire Merrill for \$29 per share, payable in Bank of America stock.

On Saturday afternoon, Lehman's counsel provided the Fed with a document describing how Lehman's default on its obligations would "trigger a cascade of defaults through to the [subsidiaries] which have large OTC [derivatives] books."⁹⁰ Bernanke, Fed Governor Kohn, Geithner, and other senior Fed officials subsequently participated in a conference call to discuss the possibility of going "to Congress to ask for other authorities," something Geithner planned to "pitch."⁹¹ However, Fed General Counsel Scott Alvarez cautioned others not to mention the plan to JP Morgan, because he did not want to "suggest Fed willingness to give JPMC cover to screw [Lehman] or anyone else."⁹²

By Saturday night, however, it appeared that the parade of horrors that would result from a Lehman bankruptcy had been avoided. An agreement apparently had been reached. Barclays would purchase Lehman, excluding \$40 to \$50 billion of assets financed by the private consortium (even though the bankers in the consortium had estimated those assets to be significantly overvalued). Michael Klein, an adviser to Barclays, had told Lehman President Bart McDade that Barclays was willing to purchase Lehman, given the private consortium agreement to assist the deal.⁹³ It seemed a deal would be completed.⁹⁴

"THIS DOESN'T SEEM LIKE IT IS GOING TO END PRETTY"

But on Sunday, things went terribly wrong. At 8:00 A.M., Barclays CEO John Varley and President Robert Diamond told Paulson, Geithner, and Cox that the Financial Services Authority (FSA) had declined to approve the deal.⁹⁵ The issue boiled down to a guarantee—the New York Fed required Barclays to guarantee Lehman's obligations from the sale until the transaction closed, much as JP Morgan had done for Bear Stearns in March.⁹⁶ Under U.K. law, the guarantee required a Barclays shareholder vote, which could take 30 to 60 days. Though it could waive that requirement, the FSA asserted that such a waiver would be unprecedented, that it had not heard about this guarantee until Saturday night, and that Barclays did not really want to take on that obligation anyway.

Geithner pleaded with FSA Chairman Callum McCarthy to waive the shareholder vote, but McCarthy wanted the New York Fed to provide the guarantee instead of Barclays.⁹⁷ Otherwise, according to the FSA, “Barclays would have had to provide a (possibly unlimited) guarantee, for an undefined period of time, covering prior and future exposures and liabilities of Lehman that would continue to apply including in respect of all transactions entered into prior to the purchase, even in the event the transaction ultimately failed.”⁹⁸

For Paulson, such a guarantee by the Fed was unequivocally out of the question.⁹⁹ The guarantee could have put the Fed on the hook for tens of billions of dollars. If the run on Lehman had continued despite the guarantee, Barclays’ shareholders could reject the acquisition, and the Fed would be in possession of an insolvent bank.

Baxter told the FCIC that Barclays had known all along that the guarantee was required, because JP Morgan had to provide the same type of guarantee when it acquired Bear Stearns. Indeed, Baxter said he was “stunned” at this development. He believed that the real reason Barclays said it could not guarantee Lehman’s obligations was the U.K. government’s discomfort with the transaction.¹⁰⁰

On Sunday morning, Treasury’s Wilkinson emailed JP Morgan Investment Bank CEO Jes Staley that he was in a meeting with Paulson and Geithner and that things did not look good. He concluded, “This doesn’t seem like it is going to end pretty.”¹⁰¹ In another note a little more than an hour later, he added that there would be no government assistance: “No way [government] money is coming in. . . . I’m here writing the usg coms [United States government communications] plan for orderly unwind . . . also just did a call with the WH [White House] and usg is united behind no money. No way in hell Paulson could blink now . . . we will know more after this [CEO meeting] this morning but I think we are headed for winddown unless barclays deal gets untangled.”¹⁰²

It did not. Paulson made a last-ditch pitch to his U.K. counterpart, Darling, without success.¹⁰³ Two years later, Darling admitted that he had vetoed the transaction: “Yeah I did. Imagine if I had said yes to a British bank buying a very large American bank which . . . collapsed the following week.” He would have found himself telling a British audience, “Everybody sitting in this room and your children and your grandchildren and their grandchildren would be paying for years to come.” That Bank of America had taken itself out of the picture may have played a role in Darling’s decision: “My first reaction was ‘If this is such a good deal how come no American bank is going to go near it?’” So Darling concluded that for Barclays to accept the guarantee, which could have a grave impact on the British economy, was simply out of the question: “I spoke to Hank Paulson and said ‘Look, there’s no way we could allow a British bank to take over the liability of an American bank,’ which in effect meant the British taxpayer was underwriting an American bank.”¹⁰⁴

Following that decision in London, Lehman Brothers was, for all practical purposes, dead. Cohen, Lehman’s counsel at the time, told the FCIC, “When Secretary Paulson came out of the meeting with Geithner and Cox, they called Lehman’s presi-

dent and me over and said, ‘We have the consortium, but the British government won’t do it. Darling said he did not want the U.S. cancer to spread to the U.K.’”¹⁰⁵

At around 1:00 P.M., Lehman’s team—President Bart McDade, CFO Ian Lowitt, Head of Principal Investing Alex Kirk, and others—reconvened at Lehman’s offices to “digest what obviously was stark news.” Upon arriving, they heard that the New York Fed would provide more flexible terms for the PDCF lending facility, which would include expanding the types of collateral borrowers could use.¹⁰⁶ McDade, Kirk, Lowitt, and Miller returned to the New York Fed building and met with the Fed’s Baxter and Dudley, the SEC’s Sirri, and others to discuss the expanded PDCF program. According to McDade and Kirk, the government officials—led by Baxter—made it plain they would not permit Lehman to borrow against the expanded types of collateral, as other firms could. The sentiment was clear but the reasons were vague, McDade told the FCIC. He said the refusal to allow Lehman to provide the expanded types of collateral made the difference in Lehman’s being able to obtain the funding needed to open for business on Monday.¹⁰⁷

Baxter explained to the FCIC, however, that Lehman’s broker-dealer affiliate—not the holding company—could borrow against the expanded types of collateral.¹⁰⁸ A New York Fed email written at 2:15 P.M. on that Sunday, September 14, stated that Lehman’s counsel was informed of the expansion of PDCF-eligible collateral but that such collateral would not be available to the broker-dealer if it filed for bankruptcy.¹⁰⁹ The minutes of Lehman’s September 14 board meeting show that the Fed rejected Lehman’s request for an even broader range of collateral to be eligible for PDCF financing and preferred that Lehman’s holding company—but not the broker-dealer—file for bankruptcy and that the broker-dealer “be wound down in an orderly fashion.”¹¹⁰ In a letter dated September 14, the New York Fed informed Lehman Senior Vice President Robert Guglielmo that the broker-dealer could finance expanded types of collateral with the PDCF, but that letter was not sent until 2:24 A.M. on September 15—after Lehman had filed for bankruptcy.¹¹¹ The Lehman broker-dealer borrowed \$20 to \$28 billion from the PDCF each day over the next three days.¹¹²

As Kirk recounted to the FCIC, during that Sunday meeting at the New York Fed, government officials stepped out for an hour and came back to ask: “Are you planning on filing bankruptcy tonight?”¹¹³ A surprised Miller replied that “no one in the room was authorized to file the company, only the Board could . . . and the Board had to be called to a meeting and have a vote. . . . There would be some lag in terms of having to put all the papers together to actually file it. There was a practical issue that you couldn’t . . . get it done quickly.”¹¹⁴ Unmoved, government officials explained that directors of Lehman’s U.K. subsidiary—LBIE—would be personally liable if they did not file for bankruptcy by the opening of business Monday. As Kirk recalled, “They then told us ‘we would like you to file tonight. . . . It’s the right thing to do, because there’s something else which we can’t tell you that will happen this evening. We would like both events to happen tonight before the opening of trading Monday morning.’”¹¹⁵ The second event would turn out to be the announcement of Bank of America’s acquisition of Merrill Lynch.

“THE ONLY ALTERNATIVE WAS THAT LEHMAN HAD TO FAIL”

Miller insisted that there had to be an alternative, because filing for bankruptcy would be “Armageddon.”¹¹⁶ Lehman had prepared a presentation arguing that a Lehman bankruptcy would be catastrophic. It would take at least five years to resolve, cost \$8 to \$10 billion, and cause major disruptions in the United States and abroad.¹¹⁷

Baxter told the FCIC, “I knew that the consequences were going to be bad; that wasn’t an issue. Lehman was in denial at that point in time. There was no way they believed that this story ends with a Lehman bankruptcy . . . they kept thinking that they were going to be bailed out by the taxpayer of the United States. And I’m not trying to convince you that that belief was a crazy belief because they had seen that happen in the Bear case.” Baxter’s mission, however, was to “try to get them to understand that they weren’t going to be rescued, and then focus on what their real options were, which were drift into Monday morning with nothing done and then have chaos break out, or alternatively file.” He concluded, “From my point of view, first thing was to convince Harvey that it was far better to file than to go into Monday and have complete pandemonium break out. And then he had to have discussions with the Lehman Board because they had a fiduciary duty to resolve what was in the best interests of the company and its shareholders and other stakeholders.”¹¹⁸

“The only alternative was that Lehman had to fail,” Miller testified to the FCIC.¹¹⁹ He stated that Baxter provided no further details on the government’s plan for the fallout from bankruptcy, but assured him that the situation was under control. Then, Miller told the FCIC, Baxter told the Lehman delegation to leave the Fed offices. “They basically threw us out,” Miller said. Miller remembered telling his colleagues as they left the building, “I don’t think they like us.”

Miller continued:

We went back to the headquarters, and it was pandemonium up there—it was like a scene from [the 1946 film] *It’s a Wonderful Life* with the run on the savings and loan crisis. . . . [A]ll of paparazzi running around. There was a guy there . . . in a sort of a Norse god uniform with a helmet and a picket sign saying “Down with Wall Street.” . . . There were hundreds of employees going in and out. . . . Bart McDade was reporting to the board what had happened. Most of the board members were stunned. Henry Kaufman, in particular, was asking “How could this happen in America?”¹²⁰

The group informed the board that the Barclays deal had fallen apart. The government had instructed the board to file for bankruptcy. SEC’s Cox called. With Tom Baxter also on the line, Cox told the board that the situation was serious and required action. The board asked Cox if he was directing them to file for bankruptcy. Cox and Baxter conferred for a few minutes, and then answered that the decision was the board’s to make. The board again asked if Cox and Baxter were telling them to file for bankruptcy. Cox and Baxter conferred again, then replied that they believed the gov-

ernment's position had been made perfectly clear at the meeting at the Fed earlier in the day.¹²¹

Following that call, McDade advised the board that Lehman would be unable to obtain funding without government assistance. The board voted to file for bankruptcy. The company filed at 1:45 A.M. on Monday morning.¹²²

"A CALAMITY"

Fed Chairman Bernanke told the FCIC that government officials understood a Lehman bankruptcy would be catastrophic:

We never had any doubt about that. It was going to have huge impacts on funding markets. It would create a huge loss of confidence in other financial firms. It would create pressure on Merrill and Morgan Stanley, if not Goldman, which it eventually did. It would probably bring the short-term money markets into crisis, which we didn't fully anticipate; but, of course, in the end it did bring the commercial paper market and the money market mutual funds under pressure. So there was never any doubt in our minds that it would be a calamity, catastrophe, and that, you know, we should do everything we could to save it.¹²³

"What's the connection between Lehman Brothers and General Motors?" he asked rhetorically. "Lehman Brothers' failure meant that commercial paper that they used to finance went bad." Bernanke noted that money market funds, in particular one named the Reserve Primary Fund, held Lehman's paper and suffered losses. He explained that this "meant there was a run in the money market mutual funds, which meant the commercial paper market spiked, which [created] problems for General Motors."¹²⁴

"As the financial industry came under stress," Paulson told the FCIC, "investors pulled back from the market, and when Lehman collapsed, even major industrial corporations found it difficult to sell their paper. The resulting liquidity crunch showed that firms had overly relied on this short term funding and had failed to anticipate how restricted the commercial paper market could become in times of stress."¹²⁵

Harvey Miller testified to the FCIC that "the bankruptcy of Lehman was a catalyst for systemic consequences throughout the world. It fostered a negative reaction that endangered the viability of the financial system. As a result of failed expectations of the financial markets and others, a major loss of confidence in the financial system occurred."¹²⁶

On the day that Lehman filed for bankruptcy, the Dow plummeted more than 500 points; \$700 billion in value from retirement plans, government pension funds, and other investment portfolios disappeared.¹²⁷

As for Lehman itself, the bankruptcy affected about 8,000 subsidiaries and affiliates with \$600 billion in assets and liabilities, the firm's more than 100,000 creditors, and about 26,000 employees. Its failure triggered default clauses in derivatives contracts,

allowing its counterparties to have the option of seizing its collateral and terminating the contracts. After the parent company filed, about 80 insolvency proceedings of its subsidiaries in 18 foreign countries followed. In the main bankruptcy proceeding, about 66,000 claims—exceeding \$873 billion—have been filed against Lehman as of September 2010. Miller told the FCIC that Lehman’s bankruptcy “represents the largest, most complex, multi-faceted and far-reaching bankruptcy case ever filed in the United States.” The costs of the bankruptcy administration are approaching \$1 billion; as of this writing, the proceeding is expected to last at least another two years.¹²⁸

In his testimony before the FCIC, Bernanke admitted that the considerations behind the government’s decision to allow Lehman to fail were both legal and practical. From a legal standpoint, Bernanke explained, “We are not allowed to lend without a reasonable expectation of repayment. The loan has to be secured to the satisfaction of the Reserve Bank. Remember, this was before TARP. We had no ability to inject capital or to make guarantees.”¹²⁹ A Sunday afternoon email from Bernanke to Fed Governor Warsh indicated that more than \$12 billion in capital assistance would have been needed to prevent Lehman’s failure. “In case I am asked: How much capital injection would have been needed to keep LEH alive as a going concern? I gather \$12B or so from the private guys together with Fed liquidity support was not enough.”¹³⁰

In March, the Fed had provided a loan to facilitate JP Morgan’s purchase of Bear Stearns, invoking its authority under section 13(3) of the Federal Reserve Act. But, even with this authority, practical considerations were in play. Bernanke explained that Lehman had insufficient collateral and the Fed, had it acted, would have lent into a run: “On Sunday night of that weekend, what was told to me was that—and I have every reason to believe—was that there was a run proceeding on Lehman, that is people were essentially demanding liquidity from Lehman; that Lehman did not have enough collateral to allow the Fed to lend it enough to meet that run.” Thus, “If we lent the money to Lehman, all that would happen would be that the run [on Lehman] would succeed, because it wouldn’t be able to meet the demands, the firm would fail, and not only would we be unsuccessful but we would [have] saddled the [t]axpayer with tens of billions of dollars of losses.”¹³¹ The Fed had no choice but to stand by as Lehman went under, Bernanke insisted.

As Bernanke acknowledged to the FCIC, however, his explanation for not providing assistance to Lehman was not the explanation he offered days after the bankruptcy—at that time, he said that he believed the market was prepared for the event.¹³² On September 23, 2008, he testified: “The failure of Lehman posed risks. But the troubles at Lehman had been well known for some time, and investors clearly recognized—as evidenced, for example, by the high cost of insuring Lehman’s debt in the market for credit default swaps—that the failure of the firm was a significant possibility. Thus, we judged that investors and counterparties had had time to take precautionary measures.”¹³³ In addition, though the Federal Reserve subsequently asserted that it did not have the legal ability to save Lehman because the firm did not have sufficient collateral to secure a loan from the Fed under section 13(3), the authority to lend under that provision is very broad. It requires not that loans be fully secured but rather that they be “secured to the satisfaction of the Federal Reserve

bank.”¹³⁴ Indeed, in March 2009, Federal Reserve General Counsel Scott Alvarez concluded that requiring loans under 13(3) to be fully secured would “undermine the very purpose of section 13(3), which was to make credit available in unusual and exigent circumstances to help restore economic activity.”¹³⁵

To CEO Fuld and others, the Fed’s emergency lending powers under section 13(3) provided a permissible vehicle to obtain government support. Although Fed officials discussed and dismissed many ideas in the chaotic days leading up to the bankruptcy, the Fed did not furnish to the FCIC any written analysis to illustrate that Lehman lacked sufficient collateral to secure a loan under 13(3). Fuld asserted to the FCIC that in fact, “Lehman had adequate financeable collateral. . . . [O]n September 12, the Friday night preceding Lehman’s bankruptcy filing, Lehman financed itself and did not need access to the Fed’s discount window. . . . What Lehman needed on that Sunday night was a liquidity bridge. We had the capital. Along with its excess available collateral, Lehman also could have used whole businesses as collateral—such as its Neuberger Berman subsidiary—as did AIG some two days later.” Fuld also rejected assertions about Lehman’s capital hole. He told the FCIC, “As of August 31, 2008, two weeks prior to the bankruptcy filing, Lehman had . . . \$26.7 billion in equity capital. Positive equity of \$26.7 billion is very different from the negative \$30 or \$60 billion ‘holes’ claimed by some.” Moreover, Fuld maintained that Lehman would have been saved if it had been granted bank holding company status—as were Goldman Sachs and Morgan Stanley the week after Lehman’s bankruptcy.¹³⁶

The Fed chairman denied any bias against Lehman Brothers. In his view, the only real resolution short of bankruptcy had been to find a buyer. Bernanke said: “When the potential buyers were unable to carry through—in the case of Bank of America, because they changed their minds and decided they wanted to buy Merrill instead; in the case of Barclays, [because they withdrew] . . . we essentially had no choice and had to let it fail.”¹³⁷

During the September 16, 2008, meeting of the Fed’s Federal Open Market Committee, some members stated that the government should not have prevented Lehman’s failure because doing so would only strengthen the perception that some firms were “too big to fail” and erode market discipline. They noted that letting Lehman fail was the only way to provide credibility to the assertion that no firm was “too big to fail” and one member stated that the market was beginning to “play” the Treasury and Federal Reserve. Other meeting participants believed that the disorderly failure of a key firm could have a broad and disruptive effect on financial markets and the economy, but that the appropriate solution was capital injections, a power the Federal Reserve did not have. Bernanke’s view was that only a fiscal and perhaps regulatory response could address the potential for wide-scale failure of financial institutions.¹³⁸

Merrill’s Thain made it through the Lehman weekend by negotiating a lifesaving acquisition by Bank of America, formerly Lehman’s potential suitor. Thain blamed the failure to bail out Lehman on politicians and regulators who feared the political consequences of rescuing the firm. “There was a tremendous amount of criticism of what was done with Bear Stearns so that JP Morgan would buy them,” Thain told

the FCIC. “There was a criticism of bailing out Wall Street. It was a combination of political unwillingness to bail out Wall Street and a belief that there needed to be a reinforcement of moral hazard. There was never a discussion about the legal ability of the Fed to do this.” He noted, “There was never discussion to the best of my recollection that they couldn’t [bail out Lehman]. It was only that they wouldn’t.”¹³⁹

Thain also told the FCIC that in his opinion, “allowing Lehman to go bankrupt was the single biggest mistake of the whole financial crisis.” He wished that he and the other Wall Street executives had tried harder to convince Paulson and Geithner to prevent Lehman’s failure: “As I think about what I would do differently after that weekend . . . is try to grab them and shake them that they can’t let this happen. . . . They were not very much in the mood to listen. They were not willing to listen to the idea that there had to be government support. . . . The group of us should have just grabbed them and shaken them and said, ‘Look, you guys could not do this.’ But we didn’t, and they were not willing to entertain that discussion.”¹⁴⁰

FCIC staff asked Thain if he and the other executives explicitly said to Paulson, Geithner, or anyone else, “You can’t let this happen.” Thain replied, “We didn’t do it strongly enough. We said to them, ‘Look, this is going to be bad.’ But it wasn’t like, ‘No . . . you have to help.’”¹⁴¹

Another prominent member of that select group, JP Morgan’s Dimon, had a different view. He told the FCIC, “I didn’t think it was so bad. I hate to say that. . . . But I [thought] it was almost the same if on Monday morning the government had saved Lehman. . . . You still would have terrible things happen. . . . AIG was going to have their problems that had nothing to do with Lehman. You were still going to have the runs on the other banks and you were going to have absolute fear and panic in the global markets. Whether Lehman itself got saved or not . . . the crisis would have unfolded along a different path, but it probably would have unfolded.”¹⁴²

Fed General Counsel Alvarez and New York Fed General Counsel Baxter told the FCIC that there would have been questions either way. As Baxter put it, “I think that if the Federal Reserve had lent to Lehman that Monday in a way that some people think—without adequate collateral and without other security to ensure repayment—this hearing and other hearings would have only been about how we wasted the taxpayers’ money.”¹⁴³

COMMISSION CONCLUSIONS ON CHAPTER 18

The Commission concludes the financial crisis reached cataclysmic proportions with the collapse of Lehman Brothers.

Lehman's collapse demonstrated weaknesses that also contributed to the failures or near failures of the other four large investment banks: inadequate regulatory oversight, risky trading activities (including securitization and over-the-counter (OTC) derivatives dealing), enormous leverage, and reliance on short-term funding. While investment banks tended to be initially more vulnerable, commercial banks suffered from many of the same weaknesses, including their involvement in the shadow banking system, and ultimately many suffered major losses, requiring government rescue.

Lehman, like other large OTC derivatives dealers, experienced runs on its derivatives operations that played a role in its failure. Its massive derivatives positions greatly complicated its bankruptcy, and the impact of its bankruptcy through interconnections with derivatives counterparties and other financial institutions contributed significantly to the severity and depth of the financial crisis.

Lehman's failure resulted in part from significant problems in its corporate governance, including risk management, exacerbated by compensation to its executives and traders that was based predominantly on short-term profits.

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.