“Lehman and the Financial Crisis”

The lesson is that institutions that take trading risks must be allowed to fail.

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One year ago today Lehman Brothers filed for bankruptcy. The weeks that followed are among the most dramatic in U.S. history. They led to a massive government intervention in the financial system—an intervention that will likely change that system forever.

Many people say that letting Lehman fail was the mistake that caused the financial crisis. To them, the lesson is that the government should never allow any "systemically important" financial institution to fail. If only Lehman had been bailed out, the story goes, we could have avoided much of a 45% drop in the S&P 500, a 4% drop in output, the rise in unemployment to 9.7% from 6.2%, and the $784 billion "stimulus" to top off a $1.59 trillion deficit.

This story is false.

The Lehman failure was not an isolated event. It was a movement in a dramatic crescendo of failures.

Two weeks prior, on Sept. 7, the government took over Fannie Mae and Freddie Mac, wiping out much of their shareholder equity. On Sept. 16, the government bailed out AIG, lending it $85 billion. On Sept. 25, Washington Mutual, the nation's sixth-largest bank, was seized by the FDIC. On Sept. 29, Wachovia, the nation's seventh largest bank, was sold to avoid a similar fate. All this would have happened without Lehman. Meanwhile, the Federal Reserve and the Treasury Department went to Congress to ask for $700 billion for the Troubled Asset Relief Program (TARP).

Which of these events set off the financial and economic crisis by freezing lending to commercial banks? The nearby chart shows that the main risk indicators only took off after Treasury Secretary Henry Paulson and Fed Chairman Ben Bernanke's TARP speeches to Congress on Sept. 23 and 24—not after the Lehman failure.

On Sept. 22, bank credit-default swap (CDS) spreads were at the same level as on Sept. 12. (CDS spreads are the cost of buying insurance against default.) On Sept. 19, the S&P 500 closed above its Sept. 12 level. The Libor-OIS spread—which captures the perceived riskiness of short-term interbank lending—rose only 18 points the day of Lehman's collapse, while it shot up more than 60 points from Sept. 23 to Sept. 25, after the TARP testimony. (Libor—the London Interbank Offer Rate—is the rate at which banks can borrow unsecured for three months.)

Why? In effect, these speeches amounted to "The financial system is about to collapse. We can't tell you why. We need $700 billion. We can't tell you what we're going to do with it." That's a pretty good way to start a financial crisis.

Subsequent reporting explained why they did it: The Fed and Treasury had felt for months that they needed legal authority to do more bailouts, and a crisis might get Congress to vote for it. But at the time, all the public saw was that our government was in a complete panic.

We inferred that the banks must be in much worse trouble than we thought. The ban on short sales of bank stocks the previous week could only reinforce that impression.

It did not help that the TARP was such a transparently bad idea. The Fed and Treasury soon figured that out, settling on equity "injections" and a bank-debt guarantee instead. Floating a bad idea does not instill confidence.

Would a Lehman bailout have averted a panic? The news would still be that Lehman failed, and markets knew bailouts would not last forever. After all, the Bear Stearns rescue in February had just postponed worse trouble.

More deeply, Lehman's lesson cannot be that the government must always bail out every large financial institution. From the 1984 failure of Continental Illinois bank to the S&L crisis of the late 1980s, the Latin American bond defaults of the 1990s, the 1997 Asian crashes, the 1998 collapse of the Long-Term Capital Management hedge fund and now this mess, financial institutions are taking more and more risks, but their bondholders keep getting rescued.

This crisis pushed our government close to its fiscal limits. The next one will be beyond what even our government can contain.

The big banks know the government will bail them out, and they are already bigger, more global, more integrated and "systemic" than ever. They are making huge trading profits—profits that must someday turn to losses. If brokerage and banking are "systemically important," they cannot be married to proprietary trading. Yet the financial-reform plans do not even talk about breaking up this marriage—they hope simply to regulate the behemoths instead.

The blame-it-on-Lehman story leads to a dangerous complacency. If we can persuade ourselves that the fault was just one policy mistake, forced on the feds by silly legal restrictions and not enough bailout power, everything can go back to the cozy way it was before.

This is a convenient story for large banks that dominate the lobbying and communication effort. And it absolves the Fed and Treasury of facing up to their long string of policy mistakes.

We don't pretend that we could have done any better. That's the point: A system with so much power vested in so few people, with so few rules, in which crises are managed with 2 a.m. conference calls, cannot possibly do better no matter how good the people at the top. Repeating the Lehman story lets us all ignore the fact that this system cannot go on.