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**Lehman Brothers and Washington Mutual Show Too Big to Fail is a Myth—  
A Myth that Prolongs the Recession and Retards Growth**

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August 23, 2010

**Abstract:** Many economists have argued that it is necessary to reorganize big banks that require sustained subsidies or are close to insolvency. By wiping out the shareholders and giving haircuts to bondholders, the resulting reorganized banks will be financially sound and capable of leading the country out of recession. But there are fears that failure of large financial institutions, especially a key player in the counterparty operations, will cause systemic financial market failure, and they are therefore “too big to fail.” However, when Washington Mutual failed, it was 6-7 times larger than the previous largest US bank to fail; it was placed into FDIC receivership and reopened literally the next day as J.P Morgan Chase, with account holders having full access to their deposits and bank services. When Lehman Brothers went bankrupt, it was the third largest user worldwide of credit default swaps for mortgage backed securities. But the Depository Trust and Clearing Corporation (DTCC) serves as a “central counterparty” guaranteeing all contracts traded under its auspices. The DTCC unwound all of Lehman’s credit default swap holdings within four weeks *with all parties receiving payment on the terms of their original contracts, i.e. there was no systemic impact from losses on the Lehman credit default swaps*. Moreover, while the DTCC indicates that it and its subsidiaries process about 95 percent of all swaps, in order to assure swaps are covered by clearing guarantees, the new financial reform law requires all eligible swaps must be submitted for clearing.

**Keywords:** too big to fail; credit default swaps, counterparty operations, financial crisis, bankruptcy, bank failure, bailouts, bondholder haircuts, receivership.

**JEL Classifications:** G00, G1, G2

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## **Lehman Brothers and Washington Mutual Show Too Big to Fail is a Myth— A Myth that Prolongs the Recession and Retards Growth**

**David G. Tarr**

*“The results of the Lehman failure on financial markets were catastrophic.”*

**Treasury Secretary Timothy Geithner**

*“The September 2008 Lehman Brothers, Fannie Mae, Freddie Mac and Landsbanki Islands credit events were managed in an orderly fashion, with no major operational disruptions or liquidity problems.”* **Senior Supervisors Group**<sup>1</sup>

Despite taking more than 130 US banks into FDIC receivership in 2009, the US government appears afraid to take large depository or investment banks into receivership for fear that failure of a very large financial institution will induce systemic financial market failure. There have been widespread allegations that the Lehman Brothers bankruptcy caused credit markets to seize. This was highlighted by the quotation above of Treasury Secretary Timothy Geithner, but other highly respected authors, such as Diamond and Kashyup (2010) and Krugman (2009a), have expressed similar views. This too big to fail fear is especially pronounced regarding bankruptcy of a central player in the counterparty (credit default swap) transactions for fear that these transactions have introduced financial interconnections that could lead to a daisy chain of bankruptcies, i.e., systemic financial market failure. Consequently, some respected analysts, for example Jaffe and Perlow (2008), contend that the credit default swap operations of large financial institutions should be regulated separately from their other operations. And partly due to fears of systemic problems from swaps trading, the Dodd-Frank Wall Street Reform and Consumer Protection Act, signed into law by President Obama on July 21, 2010, contains Title VI, known as the Volcker Rule, which prohibits insured banks from engaging in “proprietary trading.”<sup>2</sup>

These allegations regarding the implications of the Lehman Brothers bankruptcy and the problems of its credit default swaps in particular stand in sharp contrast to insider views such as the statements of the International Swaps and Derivatives Association (2008) and the Depository Trust and Clearing Corporation (2008). They are also in contrast to the conclusion of the report of the Senior Supervisors Group, quoted above, a group comprised of the senior financial regulators of the seven most important financial market economies in the world.<sup>3</sup> Given this sharp contrast in views regarding systemic

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<sup>1</sup> See Senior Supervisory Group (2009, 2). The Senior Supervisors Group investigated how financial firms managed their credit default swaps during the latter half of 2008.

<sup>2</sup> Within one week of passage of the law, Goldman Sachs had already adopted an approach designed to circumvent the regulation, and Bank of America was reportedly considering a similar approach. See “Goldman Already a Step Ahead of Financial Regulation,” Fox Business, July 27, 2010. Available at: <http://www.foxbusiness.com/markets/2010/07/27/goldman-step-ahead-finreg/>.

<sup>3</sup> The Senior Supervisors Group is comprised of the senior financial regulators of the US, France, U.K., Canada, Germany, Japan and Switzerland; the US is represented by the Board of Governors of the Federal

problems to the financial system from the credit default swaps of Lehman, it is important to examine what happened to Lehman's credit default swaps and draw lessons from it.

In this note I argue that the US experience in even the deepest period of the current financial crisis shows that very large banks can be reorganized with little or no systemic problems for the wider financial system, and this reorganization is important to create a financially sound banking system capable of leading the U.S. out of recession and toward sustained growth. I focus on the largest depository and investment bank failures: Washington Mutual and Lehman Brothers. Washington Mutual, as the nation's sixth largest bank, was 6-7 times larger than the previous largest US depository bank to fail; it was placed into FDIC receivership and reopened literally the next day as J.P. Morgan Chase. Lehman Brothers was one of the largest players worldwide in the counterparty operations for mortgage backed securities when it went bankrupt. The Depository Trust and Clearing Corporation (DTCC) and its subsidiaries made good on their guarantee by unwinding the massive credit default swap holdings of Lehman within four weeks, with all parties receiving payment on the terms of their original contracts. Moreover, through the DTCC and the Intercontinental Exchange guarantees, there are private financial market institutional mechanisms in place designed to assure that the smooth resolution of credit default swaps, as occurred in the Lehman case, will hold in general for contracts traded on their exchanges.

In addition, I summarize the results of the event analysis of John Taylor (2009), which suggests that it was not the Lehman bankruptcy that caused interest rates to jump in September 2008—rather it is more likely that the crucial event was the Bernanke-Paulson Congressional testimony eight days later. In the conclusion section, I argue that the too big to fail myth prevents restructuring the financial institutions so they are on sound financial footing. In place of allowing failure and restructuring, the government policy of bail-outs prolongs the recession and sows the seeds for the next financial crisis.

### **The Washington Mutual Bank Failure**

When Washington Mutual was placed in FDIC receivership on September 25 2008, it was 6-7 times larger than any bank that had failed in US history. It had \$310 billion in assets and \$182 billion in deposits. The previous largest bank failure was Continental Illinois National Bank and Trust with \$41 billion in assets and \$30 billion in deposits, when it failed in 1984. Despite its size, what followed was a fairly standard FDIC procedure under receivership. The FDIC wiped out the stockholders and most of the unsecured bondholders—then without bondholder liabilities, sold the bank's assets along with the customer liabilities to J.P. Morgan Chase for \$1.9 billion, and handed those proceeds over as partial recovery for the senior bondholders. Customer deposits at Washington Mutual became liabilities of J.P. Morgan Chase, and on the next day after being placed in receivership (Friday September 26, 2008) customers were able to continue banking as usual at the combined facilities of Washington Mutual and J.P. Morgan Chase. This was all done so quickly and efficiently that it has hardly even been

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Reserve, the Federal Reserve Bank of New York, the Securities and Exchange Commission and the Comptroller of the Currency. See also Whallen (2009a) for a similar view..

noticed—the Senior Financial Supervisors Group investigating the credit events of September 2008 ignored it. It should be clear that there was little or no negative impact on broader financial markets.

### **The Lehman Brothers Bankruptcy: Failure of a Key Player in the Counterparty Operations**

With \$600 billion in assets, when Lehman Brothers filed for bankruptcy on September 15, 2008, it was six times larger than the WorldCom bankruptcy, the previous largest bankruptcy in US history. Even more worrisome, Lehman was a key player in “the counterparty operations,” both in the US and internationally. The key financial instrument that has raised concern is the credit default swap (CDS). In a CDS one party buys insurance (or “protection”) from another party against default by a third party, in return for an insurance premium.<sup>4</sup> The fear is that financial institutions that prudently purchased insurance against default might not be paid in the event of default of the company providing the insurance, resulting in the insolvency of prudently operated financial institutions, with possibly cascading or systemic effects.

At the time of its failure, Lehman’s holdings of CDS were comprised of gross positions of \$329 billion in CDS on mortgage backed securities and \$190 billion in gross positions in CDS on US government securities.<sup>5</sup> Plus there were \$72 billion in CDS written on the possibility of a Lehman default itself. This made Lehman the third largest market participant in the world in CDS on mortgage backed securities, and fifth largest in CDS on government backed securities.

The Depository Trust and Clearing Corporation (DTCC) and its subsidiaries were central to the unwinding of the Lehman CDS holdings. What many will find surprising is that according to the DTCC, the **DTCC and its subsidiaries “are ‘central counterparties’ guaranteeing that most trades outstanding at the time of a bankruptcy of a member firm like Lehman are settled on the original terms.”**<sup>6</sup> Possibly due to this guarantee, the DTCC estimates that in 2008, more than 95 percent of CDS worldwide are traded through one of its subsidiaries, up from 15 percent in 2004. In addition, in March 2009, Intercontinental Exchange received authorization from the SEC to begin operations as a central counterparty, being “the buyer to all sellers and the seller to all buyers,” guaranteeing all CDS trades.

As a major participant in CDS operations under the DTCC, the Lehman failure represented a major test of the DTCC guarantee. Of the \$329 billion in the gross value of mortgage backed securities on which Lehman was an intermediary, DTCC was able to **net out** almost 90 percent of the Lehman positions in a matter of a few days. That is, Lehman was both offering “protection” to buyers of CDS in the event of a default of another company, and buying protection itself in hedging operations regarding third party

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<sup>4</sup> See Wallison (2008) for a further explanation of credit default swaps.

<sup>5</sup> See Depository Trust and Clearing Corporation (2008, pp. 2-3).

<sup>6</sup> See DTCC (2008, 2). See DTCC (2009) for an elaboration of the role of DTCC.

defaults; its net exposure was only about ten percent of the gross value of its CDS. Over the following three weeks, a DTCC subsidiary gradually sold the remaining positions on the market on its original terms with no loss to the members of the DTCC. How was the DTCC able to dispose of the net positions of Lehman without a loss to its members? The Lehman bankruptcy did not imply that the assets Lehman was insuring were at increased risk. Unless there were an increase in price (the “spread”) of protecting against the default of the underlying assets on which Lehman was offering protection, the DTCC could sell those CDS to others without a financial loss by the DTCC members. Further, as a member of DTCC, Lehman was required to post collateral on its CDS and make payments (like margin calls) when the price of the CDS changed, thereby providing some cushion against possible losses to the DTCC. Similarly, regarding the \$190 billion in Lehman holdings of CDS on government securities, another DTCC subsidiary closed out the Lehman positions on its original terms within several weeks without loss to the members of DTCC. Finally, regarding the \$72 billion in gross notional amount of CDS written by other parties on the possibility of a default of Lehman itself, after netting out positions and adjusting for the fact that Lehman bonds paid about nine cents on the dollar, those selling CDS on a Lehman failure had to pay out only \$5.2 billion as a result of the Lehman bankruptcy. These payments were made by the parties to the transactions on the terms of the contracts, again without loss to the members of the DTCC. In summary, within less than one month of the Lehman bankruptcy, all CDS positions related to Lehman were settled with all parties receiving what was due based on the terms of the original contracts without any cost to the members of DTCC. Finally, Barclays acquired the core business of Lehman, while Nomura Holdings acquired the Europe, Middle East, Asia and Pacific region businesses.

### **The Credit Crunch of the Fall of 2008 was probably not due to the Lehman bankruptcy**

Some commentators have alleged that the credit crunch of the fall of 2008 was due to the failure of the Treasury to intervene to prevent the Lehman bankruptcy during the weekend of September 13 and 14, 2008. Using an “event analysis,” however, John B. Taylor (2009) concludes that it was likely the Bernanke-Paulson testimony before Congress on September 23, 2008 that led to the credit crunch. He notes that the LIBOR—OIS spread (the key measure of risk and liquidity problems for banks) only increased slightly on Monday September 15, 2008 (to about 110 basis points) and, while the spread increased further in the following week, it was not far out of line with the spread of the previous year. Following the Bernanke-Paulson testimony on September 23, however, the spread shot up and reached a peak of more than 350 basis points by October 13, 2008 (when the TARP plan was announced). The Bernanke-Paulson testimony revealed to the public that the mortgage crisis was worse than it realized, and that the government was poorly prepared to respond.

### **Conclusion: not allowing failure prolongs the recession and retards growth**

The Washington Mutual failure shows that very large depository banks can be restructured very quickly with virtually no systemic problems. For institutions that are

important players in the counterparty operations, in the event of default of a member firm, the DTCC stands behind the smooth resolution of its trades, including its CDS, and the DTCC performed admirably in the Lehman bankruptcy--its first big test. Since March 2009, the Intercontinental Exchange also began operations on credit default swaps as a “central counterparty” guaranteeing all CDS trades. Moreover, while the DTCC estimates that 95 percent of all CDS were traded under its auspices, the financial reform bill of 2010 requires that swaps must be submitted for clearing if a registered derivatives clearing organization will accept it for clearing and the Commodity Futures Trading Commission determines it is a swap type that must be cleared.<sup>7</sup> This experience suggests that the risks are low of systemic financial market problems from failure of a large depository or investment bank.

Based on the too big to fail fear, however, the US government has designed programs, such as buying toxic assets and guaranteeing loans, to bail out the large banks.<sup>8</sup> Numerous economists, however, including Sachs (2009), Pomerleano (2009), Krugman (2009b) and Zingales (2009), have criticized these programs. The crucial problem is that the bail outs are inadequate to fix many of the banks. Rather banks which are close to insolvency are afraid to make loans, since loans involve additional risk that may induce bankruptcy. This “zombie” status of the banks prolongs the recession (Krugman, 2009a) and may delay growth in the medium term (Stiglitz, 2009). Moreover, the large volume of subsidies and loan guarantees threaten inflation,<sup>9</sup> provide incentives for high risk taking in the future (Kane, 2009), and thereby sow the seeds for the next crisis. What is required is to take the big banks that require sustained subsidies or are insolvent into receivership, wiping out the shareholders and giving haircuts to bondholders (e.g., Johnson, 2009; Buiters, 2009, Krugman, 2009a). Due to the bondholder haircuts, the resulting reorganized banks will be solvent and capable of leading the country out of recession (Bulow and Kemperer, 2009; Whallen, 2009b). Given the huge costs in failing to reorganize banks into financially viable institutions prepared to lead the country out of recession, it is worth the risks of allowing them to fail.

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<sup>7</sup> See the Congressional Research Service summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act, <http://thomas.loc.gov/cgi-bin/bdquery/z?d111:HR04173:@@D&summ2=m&>

<sup>8</sup> The federal government has invested or guaranteed more than \$300 billion dollars of Citigroup assets (and \$118 billion of Bank of America assets). Although Citigroup was attempting to pay back its TARP money to avoid constraints on executive compensation, the loan guarantees of the FDIC, Treasury and Federal Reserve have slipped under the radar. See “Assistance to Citigroup” and “Assistance to Bank of America” on the FDIC website at: [http://www.fdic.gov/about/strategic/report/2008annualreport/statements\\_dif\\_15.html](http://www.fdic.gov/about/strategic/report/2008annualreport/statements_dif_15.html).

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