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ECONOMY

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by Robert C. Pozen

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Almost exactly one year ago - on September 15, 2008 - Lehman Brothers filed for bankruptcy, and the short-term markets for non-government debt froze up around the world, forcing banks to cut back severely on lending to businesses and households alike. Many people consider Lehman's collapse as the event that tipped the world into the gravest financial crisis since 1929. Could the situation have been handled better?

Below are two lessons to be drawn from the debacle:

Lesson #1: Express a clear rationale for key decisions
The turmoil that followed Lehman's failure was a direct result of the government's failure to clearly explain why the Fed had bailed out Bear Stearns in March of 2008. This silence was misinterpreted by both investors and top Lehman execs.

If Bear Stearns was too big to fail, then many investors assumed that the Fed would bail out Lehman since it was twice as large as Bear. They continued to believe this despite a sharp spike in the cost of default protection for Lehman's bonds in the month before its demise. So when the Fed did not bail out Lehman, these investors were taken by surprise.

Similarly, Dick Fuld, the CEO of Lehman, reportedly believed that Lehman had "brand" with Henry Paulson. Since Fuld thought the Fed would come to Lehman's rescue if needed, he rejected an acquisition offer of $18 per share from the Korean Development Bank in August of 2008. In fact, Paulson did not like Fuld and was not favorably inclined toward Lehman.

The solution: require the Secretary of the Treasury to state his reasons for bailing out any financial institution and, after the fact, have the Comptroller General write a report on the costs and benefits of the bailout. Both requirements are built into a 1991 statute, passed by Congress after the bailout of Continental Illinois. However, this statute applies only to banks since no one imagined in 1991 that the Fed would be rescuing broker-dealers and insurance companies. Given the new realities, it should be extended to the federal bailout of any financial institution.

Lesson #2: Buy time to take smarter decisions

In the days just before its demise, US officials tried desperately to arrange a deal to save Lehman by spinning off its bad assets and selling the remainder to Barclays. However, Barclays needed regulatory waivers from the UK's Financial Services Authority, which balked at importing America's mortgage crisis to Europe. By Sunday, US officials had only two options – infuse massive amounts of federal monies into Lehman or let it go bankrupt.

In the future, how can the federal government expand its options to avoid such all-or-nothing situations? Two solutions spring to mind:

• Lehman filed for bankruptcy mainly because it could not borrow sufficient cash to meet its short-term operating needs. To fill the gap, the federal government could have guaranteed Lehman's commercial paper for 30 or 60 days up to a limit. In addition, many investors refused to do securities transactions with Lehman during the week before its bankruptcy filing. Again, the federal government could have guaranteed the completion of all trades with Lehman for 30 to 60 days up to a limit. Although these short-term guarantees would not have been panaceas, they would have bought more time for Lehman to find an acquisition partner or sell some of its assets.

• The FDIC has a broad range of choices when banks become insolvent - beyond putting them into receivership. For example, the FDIC can appoint a conservator or create a bridge bank to keep the operations going. But the FDIC has no such powers over investment banks like Lehman, or even holding companies of banks. Therefore, I support the Treasury's legislative proposal to extend the FDIC broad resolution powers over any insolvent financial institution that poses a serious threat to the entire financial system. Again, this would not be a panacea, but would provide policy makers with a larger toolbox to deal with financial crises.

The bill to the US government of rescuing the financial system numbers in the trillions of dollars. Arguably this bill would be substantially smaller if the authorities had handled the crisis at Lehman and other financial institutions along the lines I suggest. What other steps do you think the federal government should take in dealing with these situations?

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