Ben S Bernanke: Lessons from the failure of Lehman Brothers

Testimony by Mr Ben S Bernanke, Chairman of the Board of Governors of the Federal Reserve System, before the Committee on Financial Services, US House of Representatives, Washington DC, 20 April 2010.

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Chairman Frank, Ranking Member Bachus, and other members of the Committee, I appreciate the opportunity to testify about the failure of Lehman Brothers and the lessons of that failure. In these opening remarks I will address several key issues relating to that episode.

The Federal Reserve was not Lehman's supervisor. Lehman was exempt from supervision by the Federal Reserve because the company did not own a commercial bank and because it was allowed by federal law to own a federally insured savings association without becoming subject to Federal Reserve supervision. The core subsidiaries of Lehman were securities broker-dealers under the supervisory jurisdiction of the Securities and Exchange Commission (SEC), which also supervised the Lehman parent company under the SEC's Consolidated Supervised Entity (CSE) program. Importantly, the CSE program was voluntary, established by the SEC in agreement with the supervised firms, without the benefits of statutory authorization.

Although the Federal Reserve had no supervisory responsibilities or authorities with respect to Lehman, it began monitoring the financial condition of Lehman and the other primary dealers during the period of financial stress that led to the sale of Bear Stearns to JPMorgan Chase.[1] In March 2008, responding to the escalating pressures on primary dealers, the Federal Reserve used its statutory emergency lending powers to establish the Primary Dealer Credit Facility and the Term Securities Lending Facility as sources of backstop liquidity for those firms. To monitor the ability of borrowing firms to repay, the Federal Reserve, in its role as creditor, required all participants in these programs, including Lehman, to provide financial information about their companies on an ongoing basis. Two Federal Reserve employees were placed onsite at Lehman to monitor the firm's liquidity position and its financial condition generally. Beyond gathering information, however, these employees had no authority to regulate Lehman's disclosures, capital, risk management, or other business activities.

During this period, Federal Reserve employees were in regular contact with their counterparts at the SEC, and in July 2008, then-Chairman Cox and I negotiated an agreement that formalized procedures for information-sharing between our two agencies. Cooperation between the Federal Reserve and the SEC was generally quite good, especially considering the stress and turmoil of the period. In particular, the Federal Reserve, with the SEC's participation, developed and conducted several stress tests of the liquidity position of Lehman and the other major primary dealers during the spring and summer of 2008. The results of these stress tests were presented jointly by the Federal Reserve and the SEC to the managements of Lehman and the other firms. Lehman's results showed significant deficiencies in available liquidity, which the management was strongly urged to correct.

The Federal Reserve was not aware that Lehman was using so-called Repo 105 transactions to manage its balance sheet. Indeed, according to the bankruptcy examiner, Lehman staff did not report these transactions even to the company's board. However, knowledge of Lehman's accounting for these transactions would not have materially altered the Federal Reserve's view of the condition of the firm; the information we

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[1] Primary dealers are broker-dealers that trade in U.S. government securities with the Federal Reserve Bank of New York.

obtained suggested that the capital and liquidity of the firm were seriously deficient, a view that we conveyed to the company and that I believe was shared by the SEC and the Treasury Department.

Lehman did succeed at raising about $6 billion in capital in June 2008, took steps to improve its liquidity position in July, and was attempting to raise additional capital in the weeks leading up to its failure. However, its efforts proved inadequate. During August and early September 2008, increasingly panicky conditions in markets put Lehman and other financial firms under severe pressure. In an attempt to devise a private-sector solution for Lehman's plight, the Federal Reserve, Treasury, and SEC brought together leaders of the major financial firms in a series of meetings at the Federal Reserve Bank of New York during the weekend of September 13–15. Despite the best efforts of all involved, a solution could not be crafted, nor could an acquisition by another company be arranged. With no other option available, Lehman declared bankruptcy.

The Federal Reserve fully understood that the failure of Lehman would shake the financial system and the economy. However, the only tool available to the Federal Reserve to address the situation was its ability to provide short-term liquidity against adequate collateral; and, as I noted, Lehman already had access to our emergency credit facilities. It was clear, though, that Lehman needed both substantial capital and an open-ended guarantee of its obligations to open for business on Monday, September 15. At that time, neither the Federal Reserve nor any other agency had the authority to provide capital or an unsecured guarantee, and thus no means of preventing Lehman's failure existed.

The Lehman failure provides at least two important lessons. First, we must eliminate the gaps in our financial regulatory framework that allow large, complex, interconnected firms like Lehman to operate without robust consolidated supervision. In September 2008, no government agency had sufficient authority to compel Lehman to operate in a safe and sound manner and in a way that did not pose dangers to the broader financial system. Second, to avoid having to choose in the future between bailing out a failing, systemically critical firm or allowing its disorderly bankruptcy, we need a new resolution regime, analogous to that already established for failing banks. Such a regime would both protect our economy and improve market discipline by ensuring that the failing firm's shareholders and creditors take losses and its management is replaced.

Thank you. I would be glad to respond to your questions.