

Thomas C Baxter, Jr: Too big to fail – expectations and impact of extraordinary government intervention and the role of systemic risk in the financial crisis

Testimony by Mr Thomas C Baxter, Jr, Executive Vice President and General Counsel of the Federal Reserve Bank of New York, before the Financial Crisis Inquiry Commission, Washington DC, 1 September 2010.

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Chairman Angelides, Vice Chairman Thomas, and members of the Commission, thank you for the opportunity to appear before you today. For the past 15 years, I have been privileged to serve as the General Counsel of the Federal Reserve Bank of New York. I welcome the opportunity to speak to you about the events that brought Lehman Brothers to bankruptcy, events that occurred during 2008 when our Nation was in the midst of the worst financial crisis it has experienced since the Great Depression.

During the crisis, Federal Reserve policymakers needed to respond to a series of extraordinary and hugely consequential problems, usually with little time and imperfect information. Today I will be speaking to you about the facts surrounding one of these problems, Lehman Brothers. In 2008, my job was to provide legal advice to Federal Reserve policymakers, and so while I am happy to share with the Commission my recollections of the events that I will describe, I do not want to exaggerate my own importance. It was Chairman Bernanke, the Board of Governors, and President Geithner who made the policy determinations on behalf of the Federal Reserve System – determinations that in my view were careful, creative, and right.

With this introduction, I would like to start with a question that I am often asked about Lehman: “Why did you allow Lehman to fail?” It is an understandable question, but one that nevertheless contains a false premise. The Federal Reserve did not “allow” Lehman Brothers to die, bankruptcy being the equivalent of death to a financial company. Instead, the Federal Reserve, the United States Treasury Department, the Securities and Exchange Commission (SEC), and others tried hard to save it – not for its own sake, of course, but for the sake of all the families and businesses who would be harmed by the devastating effects of a Lehman bankruptcy. We did not succeed, but the effort made was serious and determined. We came very close.

In my remarks today, I will summarize the Federal Reserve’s actions to address the Lehman problem in two parts. In the first part, I will describe how the Federal Reserve monitored Lehman’s efforts to stabilize itself and pressed its most senior management to find a long-term solution for its liquidity and capital problems. In the second part, I will review how we attempted to facilitate a rescue from bankruptcy and, when this failed, to mitigate the impact of Lehman’s demise on the economic system as a whole.

Lehman’s decline

The New York Fed had no role in supervising Lehman Brothers. The SEC supervised Lehman’s broker-dealer pursuant to express statutory authority, and, as Chairman Mary Shapiro pointed out in her testimony before the House Financial Services Committee, the SEC also supervised Lehman’s parent holding company under a voluntary program called

the Consolidated Supervised Entity (CSE) program.¹ The Federal Reserve had a business relationship with Lehman's broker-dealer, but our transactions with the broker-dealer were for the most part repurchase agreements done for monetary policy purposes, and purchases and sales of Treasury and agency securities.

In March, events in our financial system caused several responses that expanded the Federal Reserve's business relationship with Lehman Brothers and certain other investment banks. First, the Federal Reserve announced, on March 11, 2008, what became known as the Term Securities Lending Facility (TSLF). The TSLF was designed to address a liquidity problem that we had observed with respect to certain types of mortgage-backed securities. The TSLF addressed this problem by enabling primary dealers to borrow from the Federal Reserve certain securities that they could more easily exchange for cash and secure these borrowings by pledging securities to the Federal Reserve that were less easy to exchange. This enabled the primary dealers to obtain much-needed liquidity from the market.

Second, at around the time this program was announced, one of the primary dealers, Bear Stearns, was experiencing an extraordinary liquidity run. On Friday, March 14, 2008, the New York Fed received authority from the Board of Governors of the Federal Reserve to make a loan that enabled Bear Stearns to avoid a bankruptcy filing and to continue in operation through the weekend of March 15 and 16. During that weekend, the Federal Reserve and the United States Treasury Department facilitated an acquisition of Bear Stearns by J.P. Morgan Chase. The Federal Reserve also developed a new liquidity facility to lend cash directly to primary dealers, the Primary Dealer Credit Facility (PDCF). The PDCF became operational on Monday, March 17, 2008, and it was intended to provide a liquidity backstop for primary dealers who might face circumstances similar to Bear Stearns. Lehman Brothers was one of these dealers.

It is impossible to know what would have happened to Lehman without the TSLF and the PDCF, but it is safe to say that these facilities calmed markets and allowed Lehman and others more time to examine available options and to seek potential solutions. As history shows, Lehman had six months from the date of the Bear Stearns transaction to find a long-term solution to its myriad problems. Of course Lehman's challenges were very serious – it suffered from capital deficiency, liquidity drain and a low level of market confidence. Any of these three could potentially prove fatal to a publicly traded financial company, even in the healthiest of economies. Lehman had the misfortune of trying to solve all three at once.

With the introduction of the TSLF and the PDCF, the New York Fed sent small teams of two monitors into each of the four remaining investment banks, Goldman Sachs, Merrill Lynch, Morgan Stanley and Lehman Brothers – something it had never done before. Let me again emphasize that we were not intending to conduct supervisory activities with our personnel, nor were we attempting to displace the SEC, the primary regulator of the investment banks. To the contrary, we were acting as a potential lender to these potential borrowers, and we wanted to know our new borrowers better. Because of concern that our monitoring role could be misunderstood or misconstrued, Vice Chairman Donald Kohn described our objectives in public testimony. He said that the on-site monitors had two narrowly tailored goals: (1) to ensure that any credit that the Fed extended to the investment banks would be repaid, and (2) to ensure that the investment banks did not become too dependent upon Federal Reserve credit and would continue to work on improving their liquidity positions and financial strength.² The Federal Reserve monitors did not take on the broader responsibility of

¹ Mary L. Schapiro, Chairman, U.S. Securities and Exchange Commission, *Testimony Concerning the Lehman Brothers Examiner's Report*, before the United States House of Representatives Committee on Financial Services, April 20, 2010.

² Donald L. Kohn, Vice Chairman, Board of Governors of the Federal Reserve System, *Risk Management and Its Implications for Systemic Risk*, before the Subcommittee on Securities, Insurance, and Investment, Committee on Banking, Housing, and Urban Affairs, United States Senate, June 19, 2008.

supervising Lehman. The SEC continued to be the supervisor of the broker-dealers and their parents, including Lehman's broker-dealer and its parent, Lehman Holdings.

Lehman showed some signs of recovery during this period. It raised capital in June of 2008. But liquidity continued to be a significant disability. As part of its monitoring, the New York Fed, in conjunction with the SEC, conducted liquidity stress analyses of the investment banks, in part to evaluate their creditworthiness. Those analyses suggested that Lehman needed to improve its liquidity should the credit crisis intensify. Again, to Lehman's credit, and in response to our analyses, Lehman took steps to, and did, improve its liquidity. At no time, however, did anyone at the New York Fed believe that Lehman had sufficient liquidity to withstand what was to come in September, events that Richard Fuld, Lehman's former chief executive officer, has described as the "perfect storm."³

Accordingly, as has been well-documented in the press and in the comprehensive report by Anton Valukas, the Lehman Brothers' bankruptcy examiner (the Valukas Report), senior Federal officials, including President Geithner, continually pressed Lehman to find workable solutions for its capital and liquidity problems from March to September 2008. Lehman executives pursued potential merger partners. They engaged in discussions with potential Korean buyers and approached Warren Buffett. At no time did the New York Fed tell Lehman that it would be bailed out with taxpayer money, nor did the New York Fed instruct Lehman to act as if such an option was available. Lehman's CEO, Mr. Fuld, and the Chairman of the Lehman board of directors, Thomas Cruikshank, have made clear that Lehman was not expecting any Federal bailout.⁴ Both men fully understood that Lehman was a public company and needed to be fully responsible for its own financial situation.

Lehman weekend

September of 2008 will likely be remembered as an epochal period in the history of American finance. The bankruptcy filing by Lehman occurred during that month, and it must be analyzed in the context of that most distressing time. On September 7, the Federal Housing Finance Agency placed Fannie Mae and Freddie Mac into conservatorship, and the Treasury Department used its authority, granted by Congress in July 2008, to make financial support available to these two government-sponsored entities. While Lehman is often considered the trigger for the systemic consequences that were to come later in the month, it is also clear that Fannie and Freddie's decline, among other factors, caused a number of market participants to begin "hunkering down" to protect their balance sheets. Exposure to Lehman was one of the items to be addressed. Counterparties' reluctance to deal with Lehman intensified starting on Monday, September 8, 2008, such that by Thursday, September 11, 2008, it was apparent to us that Lehman faced a liquidity crisis – i.e., it would not be able to pay its debts as they came due. The issue was no longer whether this public company could fashion its own rescue. We had come to the point of no return, where Lehman faced two alternatives: bankruptcy, or some kind of third-party rescue.

The United States Treasury Department, working in conjunction with the Federal Reserve and the SEC, convened a meeting of the chief executive officers of major financial institutions at the New York Fed after the close of markets on Friday, September 12, 2008. Secretary Paulson opened the meeting with a short and plain declaration that there would be no public money to support Lehman. The Government then gave the CEOs two tasks. First, it was suggested they form a consortium to finance certain of Lehman's illiquid assets in

³ Richard S. Fuld, Jr., *Statement before the United States House of Representatives Committee on Financial Services*, April 20, 2010.

⁴ Transcript, Hearing on Lehman Brothers Bankruptcy Examiner Report, United States House of Representatives Committee on Financial Services, April 20, 2008, pp. 136, 153.

order to facilitate an acquisition. Second, as a contingency, should the banking organizations fail to come up with a workable rescue plan, they should present an alternative plan to address the effects of a Lehman bankruptcy, because they should anticipate that would happen Monday morning.

As was the case with Bear Stearns, the Government knew that a third party would have to finance a portfolio of Lehman's illiquid assets in order to make Lehman acceptable as a merger partner. In this case, drawing upon the precedent of the rescue of Long Term Capital Management in 1998, the Government arranged for a consortium of private banks to provide the financing. And in fact, after much discussion and some disagreeable moments, the private banks agreed to do so. By Sunday, September 14, the counterparties had agreed to finance approximately \$30 billion of Lehman's illiquid assets in order to facilitate Lehman's rescue. While the structure was never finalized, it would presumably have resembled a private sector version of Maiden Lane LLC, the vehicle used to acquire the assets from Bear Stearns. The banks would have lent \$30 billion to their SPV, and the special purpose vehicle (SPV) would have purchased largely real estate-related assets from Lehman. This would have made Lehman more attractive to a potential acquirer.

Lining up financing for the illiquid assets was a necessary condition for a rescue, but it was not sufficient. The sine qua non of the plan, as Secretary Geithner and others have pointed out, was a willing and capable merger partner.⁵ In the end, the rescue failed because we had no willing and capable merger partner able to provide the necessary commitments to stabilize Lehman. And, lest there is confusion on the point, this would be true no matter who was financing the acquisition of Lehman's illiquid assets, the counterparties or the New York Fed.

As of that Friday, there were two prospective Lehman acquirers: Bank of America and Barclays. On Saturday, September 13, Bank of America abandoned the potential acquisition of Lehman and reached an agreement to acquire Merrill Lynch. Barclays was the only remaining suitor. On Sunday, September 14, with the consortium financing committed, we learned for the first time that Barclays would not be able to deliver a key document to carry the merger to conclusion: a guarantee of Lehman's trading obligations between the signing of the merger agreement and its closing.

The Bear Stearns transaction taught us the importance of the guarantee to a successful rescue. A guarantee maintains the ability of the troubled company to operate as a going concern and, thus, preserves value. It does this by providing protection to counterparties during an especially vulnerable period – the period between merger contract and merger closing. Without such a guarantee, the creditors and counterparties of the firm would be at risk in the event that the merger fell apart because of a failed shareholder vote or some other contingency. Consequently, as a market matter, the guarantee is an indispensable part of any such rescue operation.

On Sunday, September 14, we learned that Barclays could not proffer the needed guarantee without a shareholder vote. This vote would take days, if not weeks or months, and there was no way to predict if the shareholders would even vote for the transaction to proceed. I explored with counsel whether the U.K. government, or one of its instrumentalities like the FSA, might waive this U.K. requirement, such that the guarantee could be delivered and the rescue effected. I learned that the U.K. authorities were not amenable to a waiver. Thus, Barclays ceased to be available as the willing buyer that we needed to rescue Lehman, and there was no other interest from any firm of sufficient size and capability that could acquire Lehman, a company with consolidated assets of about \$600 billion.

⁵ Timothy F. Geithner, Secretary of the Treasury, *Statement before the United States House of Representatives Committee on Financial Services*, April 20, 2010.

Many have asked why, when the Barclays guarantee problem presented itself, the Federal Reserve did not step forward and guarantee the trading obligations of Lehman pending its merger with Barclays. They observe that we lent approximately \$29 billion to Maiden Lane LLC to facilitate the merger of J.P. Morgan Chase and Bear Stearns, and they look at our commitment to lend up to \$85 billion to AIG.

Under the law, the New York Fed does not have the authority to provide what I would characterize as a “naked” guarantee – one that would be unsecured and not limited in amount, and would put the U.S. taxpayers at risk for the *entirety* of Lehman’s trading obligations. As Chairman Bernanke has observed, “the Federal Reserve has done, and will continue to do, *everything possible within the limits of its authority* to assist in restoring our nation to financial stability and economic prosperity....”⁶ In this case, Lehman had no ability to pledge the amount of collateral required to satisfactorily secure a Fed guarantee, one large enough to credibly withstand a run by Lehman’s creditors and counterparties. As events subsequently played out, several weeks after Lehman weekend, on October 2, 2008, Congress passed the Emergency Economic Stabilization Act (EESA), which provides the U.S. Treasury Department with legal authority to issue a guarantee.⁷ Again, the Federal Reserve did not then, and does not now, have such authority.

Even if it had been legally possible, a Government guarantee would have also placed the taxpayer at enormous risk because it would have undermined deal certainty. It is important for the acquirer – and not a third party – to issue the guarantee because it gives the acquirer a strong incentive to close the deal and assume control of the target. For example, J.P. Morgan Chase, which proffered the guarantee needed to merge with Bear Stearns, negotiated a host of provisions from Bear Stearns that assured deal certainty. And, during the period between March 2008 (when J.P. Morgan Chase and Bear Stearns agreed to merge) and June 2008 (when the merger closed), counterparties of Bear Stearns continued to do business with it because of the J.P. Morgan Chase guarantee.

On the other hand, where a third party provides the guarantee, the acquirer enjoys all the benefits if the target’s condition improves and none of the burdens if the target’s condition declines. It is the third party who is on the hook, and in this case that third party would have been the taxpayer. Similarly, from the perspective of the merger target, an unlimited guarantee by the Government could provide the merger target with the means to try to stay independent – its shareholders might vote the merger down with an unlimited Government guarantee.

Some observers ask why if we were not able to backstop Lehman, we were able to provide substantial credit to AIG immediately afterwards. The answer is that in the case of AIG, there was sufficient collateral to support the commitment to lend. Unlike the naked guarantee needed to facilitate the merger of Barclays and Lehman, our committed credit to AIG on September 16, 2008, was fully secured by good collateral, namely, AIG’s sound retail insurance businesses. In fact, before any money was disbursed to AIG on September 16, AIG delivered share certificates to the New York Fed that we continue to hold as collateral in our vaults. These shares fully secured every penny we lent to AIG on September 16, 2008. And today, the credit extended to AIG by the New York Fed remains fully secured.

Likewise, the Federal Reserve’s loan to Maiden Lane LLC, which facilitated the Bear Stearns rescue, was and is fully secured. The security is important because it is the taxpayer’s

⁶ Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, ***Federal Reserve Policies to Ease Credit and Their Implications for the Fed’s Balance Sheet***, National Press Club Luncheon, National Press Club, Washington, D.C., February 18, 2009 (emphasis added).

⁷ See EESA, §102(c)(4), “Adjustment to purchase authority” (“The purchase authority limit in section 115 shall be reduced by an amount equal to the difference between the total of the outstanding guaranteed obligations and the balance in the Troubled Assets Insurance Financing Fund.”)

protection in the event of a default. There is no similar protection to the issuer of a naked guarantee; if the obligor of the guaranteed obligation fails to perform, the guarantor is liable.

On Sunday, September 14, with an acquisition of Lehman no longer possible, a working group of market participants focused on the best way to mitigate the effects of a Lehman bankruptcy. They concluded that a contingency plan developed by the SEC, the Treasury, and the New York Fed was the best option. Under this plan, Lehman's parent would file a Chapter 11 petition, but the broker-dealer subsidiary would continue to operate. It would operate with intra-day credit from its clearing bank, J.P. Morgan Chase, and overnight credit from the Federal Reserve.

The Federal Reserve would provide credit that was fully secured by the collateral of the broker-dealer and this would continue for a period of time to enable the broker-dealer to wind down its trading book in an orderly manner – thereby mitigating to some degree the impact of the failure on financial markets and the economy. At the point in time when an orderly liquidation of the broker-dealer became practical, a petition would be filed for a receivership under the Securities Investor Protection Act. This became the contingency plan, although it was always subject to the Lehman board of directors deciding to file a Chapter 11 petition, a matter that was their responsibility and not ours. On September 15, Lehman's board of directors elected to place the parent company in Chapter 11 while leaving Lehman's broker-dealer open for business so it could wind down its operations.

A look at the hypothetical alternative of lending to the Lehman holding company itself reveals that it was in fact not viable. By Monday, September 15, Lehman faced a total erosion of market confidence, and so the Federal Reserve would have been lending into a classic run. Had Lehman not filed for bankruptcy on September 15, but opened as if it were business as usual, creditors and counterparties would have rushed to protect their positions, using all legal remedies, causing the liquidity crisis to spread throughout Lehman's organization.

By contrast, the New York Fed affirmatively decided to continue extending credit to Lehman Brothers' broker-dealer. This decision was made to facilitate the broker-dealer's orderly winddown. Then, when Barclays returned to the negotiating table on Tuesday, September 16, with an offer to purchase substantially all of the assets of Lehman's broker-dealer, the New York Fed used this financing to facilitate a transition of certain broker-dealer operations from Lehman to Barclays. Once Judge Peck of the United States District Court for the Southern District of New York approved the arrangement at the end of the week, those operations were in Barclays' hands.

While there was nothing truly "orderly" about the Lehman bankruptcy, the New York Fed's overnight financing of the Lehman broker-dealer avoided further market disruption. This piece of the overall Lehman story is rarely told, and yet it deserves attention. In contrast, Lehman Brothers International Europe (LBIE), the U.K. broker-dealer, was immediately placed into administration, its employees were sent home without paychecks, and the U.K. broker-dealer had no opportunity to wind down its positions. As such, its counterparties' positions were likewise frozen, which created liquidity problems and significant market exposures as asset prices moved in the wake of Lehman's failure.

Conclusion

In conclusion, let me say a few words about regulatory reform and the tools we had to work with. I mentioned earlier the guarantee tool that the Congress added when the EESA was enacted. Another important development is the Dodd-Frank legislation, which promises more effective comprehensive consolidated supervision of systemically significant organizations like Lehman. This supervision will demand higher levels of capital and liquidity, precisely the type of medicine that Lehman needed. Systemically significant non-banking financial companies, like Lehman, will also be obliged to submit resolution plans which will help to avoid some of the problems experienced after Lehman filed its Chapter 11 petition. Further, if

a systemically significant organization like Lehman needs to be resolved, Dodd-Frank creates a new resolution procedure that should facilitate a more orderly winddown.

Thank you again for the opportunity to appear before you today, and I look forward to answering your questions.