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Lehman Brothers and the Persistence of Moral Hazard

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One year ago, Lehman Brothers filed for bankruptcy, triggering the most acute phase of the financial crisis. The precipitating cause of Lehman's demise was a decision -- by Treasury Secretary Henry Paulson, Federal Chairman Ben Bernanke and New York Fed President Timothy Geithner -- to send a message. Paulson is quoted in David Wessel's "In Fed We Trust" as saying: "I'm being called Mr. Bailout. I can't do it again." Geithner, for his part, was more circumspect, saying, "There is no political will for a federal bailout."

This made sense on the surface. Not only is it questionable public policy to use taxpayer money to bail out private companies, but, more important, it creates a moral hazard: the incentive for those companies to take excessive risks with the knowledge that the government will save them should things go wrong.

Of course, the plan backfired completely. The chaos that ensued forced the government to step in to protect almost every financial instrument involved in the credit markets, from money market funds to commercial paper to asset-backed securities, and to ride to the rescue of some of America's largest banks. In the process, the government created moral hazard on an epic scale, transforming a vague expectation that certain financial institutions were "too big to fail" into a virtual government guarantee.

We wrote last September, along with many other observers, that the decision to let Lehman fail was a mistake. (There is a minority, including the principals involved, that argues that the Fed did not have the power to rescue Lehman. We think this is belied by the fact that, one day later, the Fed discovered the power to rescue AIG -- an insurance company only tenuously under its jurisdiction.) But whatever tactical decision had been made on the weekend of Sept. 13-14, 2008, the problem of moral hazard was already too deeply rooted to be easily solved.

Moral hazard already existed in the system on at least three levels.

First, bank employees and managers had asymmetric compensation structures. In good years, they stood to make huge amounts of money; in bad years, even if the bank lost money, they would still make healthy sums. This gave employees the incentive to take excessive risks because they could shift their potential losses to shareholders.

Second, shareholders had the same payoff structure. Banks are highly leveraged institutions; every dollar contributed by shareholders is magnified by 10 to 30 dollars from creditors. This meant that in good years, shareholders benefited from profits that were juiced by leverage, but should things go wrong, they could shift their potential losses to creditors. As a result, paying bank executives in stock did not mitigate their behavior; in fact, the most senior executives at both Bear Stearns and Lehman had and lost enormous amounts of money tied up in their companies.

Third, creditors had only limited incentives to watch over major banks. Ordinarily, creditors should demand high interest rates on loans to highly leveraged institutions. However, the expectation that large banks would not be allowed to fail made creditors more willing to lend to them. This is why the failure of Lehman was such a damaging blow: It shattered market expectations that the government would not let a major bank fail. The massive flight of money out of the banking system can be seen only as the result of an enormous shock. The next several months, up through the third bailout of Citigroup in February, can be seen as the government's attempt to undo the damage by repeatedly saying "No more Lehmans" -- which has made the implicit government guarantee stronger than ever before.

So while the decision to let Lehman fail was a mistake, rescuing Lehman would not have prevented the financial crisis; most likely it would have only reduced the degree of panic and the amount of collateral damage to the global economy.

If the Obama administration is serious about preventing a future financial crisis, it will have to address these three forms of moral hazard. However, its proposals may not be adequate to the task.

The proposed solutions to skewed compensation structures are "say on pay" (allowing shareholders to vote on compensation packages) and increased independence of board compensation committees. However, at best this ensures that managers have the same incentives as shareholders -- which they already do, for the most part. These reforms do not address the problem that shareholders like the fact that banks are highly leveraged institutions.

Another approach to limiting moral hazard is giving the government "resolution authority" for large financial institutions, similar to the FDIC's power to shut down commercial banks. This would theoretically give the government the ability to wind down a bank in an orderly fashion while imposing "haircuts" on creditors; this would, in turn, give creditors the incentive to watch more closely over their borrowers.

While we support giving the government this authority, it is questionable what impact it would have on market behavior. Resolution authority carries a meaningful threat only if market participants believe the government would actually use it in a way that harms shareholders and creditors . . . and the government has just spent months insisting that harming either shareholders or creditors is a mistake.

The Treasury Department has also proposed tightening capital requirements on large banks, which could make it harder for them to borrow large amounts of money. But this would do little to change the incentives at work; it would at best reduce the amount of damage that a bank could cause on the way down.

If moral hazard cannot be effectively minimized, then the alternative solution is stricter regulation. That is, instead of trying to create the right incentives for private-sector actors to do the right thing, the government would have the power to simply demand that they do the right thing -- or, at least, that they not do the wrong thing. This is a path that this administration seems reluctant to go down. As a result, we may find ourselves attempting to contain moral hazard, on a trial-and-error basis, for years to come.