# Market failure expert says letting Lehman go was good thing

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Approaching the anniversary of Lehman Brothers' demise, NJIT Finance Professor Michael Ehrlich, an expert on market failure, says that the Feds made the right move when they allowed the investment firm to go bankrupt.

"It would have been much worse had the Federal Reserve and Treasury officials allowed Lehman Brothers to stay in business," said Ehrlich. "Lehman was the trigger, but not the cause of our financial problems. A Lehman rescue would only have allowed the financial crisis to grow."

"The Unexpected Consequences of Financial Innovation: The Evolution of Structured Investment Vehicles," co-authored by Ehrlich, will reiterate this theme plus more next month when the article appears in Bank Accounting and Finance.

Last year, Ehrlich co-authored a study of the financial crisis which explained some of the structural flaws and predicted some of the subsequent outcomes. "SIVs: Could You Survive a Financial Collapse?" appeared in The Journal of Corporate Accounting and Finance.

Ehrlich believes that structural adjustments to financial markets that may occur through either financial innovations or via government actions often have unexpected consequences. The earlier bailouts of Bear Stearns, Fannie Mae and Freddie Mac set the stage for market expectations for future bailouts. The Federal Reserve had established too-big-to-fail as an important new standard before Lehman fell.

The previous government rescues encouraged the moral hazard of imprudent risk-taking by financial managers because they signaled that risky behaviors will be bailed out. To encourage firms to reduce their leverage and financial risk, government regulators had to change market expectations.

"There is no gentle way to pop a financial market bubble," said Ehrlich. Experience from the Japanese market collapse of the early 1990's and of the U.S. Savings and Loan crisis of the 1980's suggests that earlier and quicker action are the best ways to minimize damage from a financial market meltdown.

The Fed is already working on a good proposal to reduce incentives for very large firms to take on too-risky positions, he added. By requiring larger firms to maintain a higher percentage of their assets as reserves, they both discourage firms from becoming too big to fail and require already large firms to moderate their risk.

Prior to joining NJIT, Ehrlich, an assistant professor, was a government arbitrage trader at Salomon Brothers and a senior managing director at Bear Stearns. He received his bachelor's degree from Yale University and PhD from Princeton University.

Source: New Jersey Institute of Technology

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