LEHMAN BROTHERS: TOO BIG TO FAIL?

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INTRODUCTION

In this case study an example of a large bank failure and its after effects on the financial markets is presented and raises issues relating to "too big to fail". In this situation government, regulatory, and supervisory agencies were forced to address the public policy issues surrounding when, and if, an individual financial institution should be bailed out. In the case presented here the decisions needed to be made during a time of unsettled market conditions and, as is always the case, within a very short time frame leaving ample opportunity for public debate after the fact.

BACKGROUND

Lehman Brothers began trading in buying and selling cotton in the state of Alabama in the 1850's enjoying prominence in a small market. The brothers had ambitions to grow outside the local market and soon opened an office in New York. Lehman Brothers helped form the first commodities futures trading venture in the U.S. by opening the New York Cotton Exchange. The company also helped establish the Coffee and Petroleum Exchange. Later the firm moved away from strictly dealing in commodities to merchant banking. The bank enjoyed much success and was an important asset on Wall Street.

The company was a conservative close knit family enterprise until 1969 when the last family member left the firm. The firm then experienced a period of turmoil which pushed the company to seek a merger with another familiar name on Wall Street.

The company was spun out in 1969 through a public offering and became an investment bank holding company named Lehman Brothers Holdings, Inc. The Chief Executive of the Company was Richard Fuld. He was known to be very aggressive even for Wall Street and the company followed the familiar Wall Street template of taking big risks and reaping large rewards.

Lehman was late into the subprime securitization game and relatively early to start winding down after the collapse of the Bear Stearns hedge fund. This said, the firm retained an outsized position in the lower quality lower rated mortgage tranches at the bottom of the securitization chain. The firm also had accumulated a very large commercial real estate portfolio.
The CEO of Lehman believed that the firm had sufficient access to the money market and could not fail after the Federal Reserve allowed investment banks to borrow after the Bear Stearns debacle.

Lehman was very highly leveraged and was taking no steps to get borrowing under control.

After the Government rescued Freddie Mac and Fannie Mae on September 7th and Lehman announced a large third quarter loss three days later the bank began to have pronounced liquidity problems. A large New York clearing bank asked the firm to provide more collateral to protect any daylight open position that may arise. Credit rating agencies threatened to downgrade the company unless some reasonable plan was announced that would restore capital and stabilize funding. Lehman had no such plan. That weekend, after exhausting private sector solutions, the government made it clear that no public money would flow to Lehman. Lehman Brothers Holdings, Inc. filed for bankruptcy.

Key Issues

- Weak supervision can lead to a bank taking undue risk and failing to maintain sufficient capital against the constellation of risks it faces
- Identifying when an institution is too big to fail when no depositors interests are at stake
- Oversight of a financial holding company where there is no legal authority
- Whether it is better to have a public policy on when the government should intervene or is constructive ambiguity still relevant

Learning Objectives

The Toronto Centre program provides you with simple but powerful processes to strengthen your leadership skills in your supervisory function. Each case used in the program enhances specific leadership capabilities.

This case is designed to enhance your ability to:

- Understand the debate between too big to fail and too important to the financial system to disappear
- Understand how markets react to government rescue attempts
- Understand how lack of coordination among supervisors and absence of a robust supervisory plan can lead to a bank’s failure
- Understand how lack of effective market oversight can lead to systemic weakness
Core Principles

Core Principle 1 requires “an effective system of bank supervision” to “have clear responsibilities and objectives for each authority involved in the supervision of banks”. “A suitable legal framework for banking supervision is also necessary”.

Core Principle 6 requires supervisors to “set prudent and appropriate capital adequacy requirements for banks that reflect the risks that the bank undertakes”.

Core Principle 7 states that “supervisors must be satisfied that banks and banking groups have in place a comprehensive risk management process to identify, evaluate, monitor, and control or mitigate all material risks and to assess their overall capital adequacy in relation to the risk profile”.

Core Principle 8 notes that “banks should have a credit risk management process that takes into account the risk profile of the institution”.

And lastly Core Principles 13 and 14 deal with banks having in place proper and adequate policies, practices and procedures addressing and controlling risks related to market and liquidity risks.

This case study demonstrates the need for proper supervisory oversight and strengthened coordination among supervisors and Self-Regulatory Organizations.

CASE NARRATIVE

THE COMPANY

In the 1840's Henry Lehman started a business selling groceries, dry goods and utensils to cotton farmers in Alabama. In 1850 his two brothers, Emanuel and Mayer, joined the small business which was then named Lehman Brothers. Lehman Brothers soon moved away from the general merchandising business into the more lucrative trade of buying and selling cotton.

The business expanded quite rapidly once the brothers built a large cotton warehouse. An office was opened in New York in 1858 giving Lehman Brothers a footprint in the expanding commodities trading business and a toehold in the financial community.

The business suffered greatly during the U.S. Civil War as the South's economy was destroyed and its primary export crop, cotton, was lost. After the war the company largely
moved its operations to New York and continued to deal primarily in commodities. Lehman Brothers organized the formation of the New York Cotton Exchange which was the first commodities futures trading venture. The Company also helped to establish a Coffee Exchange and a Petroleum Exchange.

The firm was asked to underwrite the first state bond issue for Alabama after the war and become the fiscal agent for the state. Thus the firm began a long tradition of municipal finance.

In the latter part of the 19th century the formation and construction of railroads was a booming business in need of financing. Traditional methods of financing at that time relied largely on wealthy individuals but the massive need for financing pushed firms to structure bonds in such a way as to draw in individual first-time investors. Lehman Brothers expanded its commodity business to include selling and trading securities, joined the New York Stock Exchange, and moved from commodity trading to merchant banking. The firm also became more important in financial advisory services which set the stage for it to become a big player in the underwriting business later in the 20th century. In the early 1900's Lehman was a leader and a primary underwriter in the emerging retail sector which included many famous names like Woolworth, Sears, Gimbel's and Macy's.

The firm grew rapidly underwriting emerging industries like airlines, the motion pictures and entertainment industry, the oil sector including extraction, development, and production as well as continuing its strong support of the retail sector.

Lehman Brothers remained a family-only partnership until 1924 when the first non-family members were brought in.

During the Depression it was difficult for even strong companies to raise capital. Lehman was one of the first firms to use private placements as a way to replace public financing with private lending, a common method today but innovative in its day.

The 1950's began to see the dawning of the electronic and computer sectors and Lehman quickly sought opportunities in these areas.

In the 1960's the firm expanded its capital markets and trading capabilities and became a leader in commercial paper and a primary dealer in U.S. securities. As American companies began to move to overseas markets, Lehman followed and increased its global presence by setting up offices in Europe and Asia.
The last Lehman family member left the company in 1969. There was no clear line of succession. The Company was also facing severe headwinds because of the poor economic climate at that time.

In the 1980's much energy was focused on mergers and acquisitions both domestically and internationally and Lehman was a key advisor for many of these transactions. There also were a number of acquisitions aimed at rounding out the firm's business platform and moving it to the fourth largest investment bank in the U.S. The firm enjoyed considerable success with one of the highest returns on equity in the business.

Hostilities between the firm's investment bankers and equity and commodity traders caused internal strife. An ex-Chairman of the firm's M&A committee recalls in an interview that "Lehman Brothers had an extremely competitive environment which ultimately became dysfunctional." The company suffered under the internal dissention and senior management was pressured to sell the firm. From 1984 through 1994 Lehman Brothers was a part of the American Express Companies and during this time was focused largely on brokerage rather than investment banking.

In 1994 Lehman was spun out of American Express in an initial public offering and became Lehman Brothers Holdings, Inc.

Lehman's global headquarters were destroyed during the attack of the World Trade Center on September 11, 2001.

THE PROBLEMS

Richard J. Fuld, the Chairman of Lehman Brothers, spent his entire forty-two year career at the company rising from the trading floor to the executive floor. Fuld was a classic Wall Street personality noted for taking big risks and reaping large rewards with a great intensity and an expectation of loyalty from the staff. Fuld ruled by intimidation and his brutality was legendary. His motto was "never surrender". He neither sought nor accepted counsel from his senior managers. His time was spent in his office on the 31st floor building the asset base that ended up causing the firm's demise. Despite his fierce reputation Fuld was a much admired Wall Street CEO but his experience and solo management style served him poorly when he, like many others, miscalculated the severity of the market upheaval.

Lehman was a global financial services firm serving corporations, local federal and state governments, institutions, and high net worth customers. Its focus was largely in equities and fixed income products, trading and research, investment banking and asset management.
Retail was not a major product line. Leman felt it was losing out on the huge profits other Wall Street firms were enjoying from slicing and dicing America's home mortgages. Lehman began to enter this business in earnest in 2005 ignoring warnings that the U.S. housing market had become dangerously overheated and mortgage brokers were handing out money to individuals who could never pay. Lehman started to exit the business in August 2007 right after the collapse of two hedge funds sponsored by Bear Stearns that were invested in complex derivatives backed by home mortgages. The collapse of the two hedge funds focused the market's attention on the value of subprime mortgages. Lehman closed its subprime lender, BNC Mortgage, but retained an outsized position in subprime debt especially the lower quality lower rated mortgage tranches at the bottom of the securitization chain. It is uncertain whether Lehman did this because it was simply unable to sell the low rated bonds or senior management made a conscientious decision to hold on to them hoping the impairment in value was only temporary.

Lehman Brothers took false comfort in the fact that their balance sheet was heavily weighted in commercial real estate which management thought was immune from the growing problems in the residential housing sector and far away from the toxic brew of collateralized debt obligations polluting other investment banks’ books. Lehman had the largest commercial real estate portfolio on Wall Street. The firm considered itself an expert in financing commercial real estate. Lehman paid high prices at the top of the market and management maintained an optimistic view of the portfolio's worth despite growing evidence that this sector was also in trouble. Lehman's commercial property book was out of control, an $80 billion accumulation of fantasy real estate projects. Lehman was a ticking time bomb.

The Securities and Exchange Commission in the United States had net capital rules in place since 1925 which, among other requirements, held securities firms to a leverage ceiling of 12 to 1. Firms were required to notify the SEC and the public if they were coming close to the limit and cease trading if they exceeded the limit. In 2004 the EU passed new rules allowing computerized models and doing away with the discounts and haircuts historically used in computing net capital. The new EU rules also allowed significantly larger leverage in the consolidated firm - up to 40 to 1.

Financial firms operating in the EU have to be subject to consolidated supervision. Lehman Brothers and the four other U.S. investment banks had no consolidated supervisor as the U.S. law was silent on this point. The SEC instituted a voluntary program called the Consolidated Supervision Entities (CSE) program which was designed to meet the requirements for consolidated supervision. There were significant flaws in this program which rendered it ineffective. (See Appendix). Regardless of the voluntary nature of the program and the suspect ability of the SEC to enforce any rules the SEC justified allowing the firms in the program more
generous leverage and reduced capital rules because the CSE program allowed the firm to better manage risk on a consolidated basis. In reality Investment Bank Holding Companies, including Lehman Brothers Holding, Inc., had no formal regulatory oversight, no liquidity requirements, no leverage constraints, and no capital rules.

To enhance returns Lehman Brothers became addicted to debt which put the bank at even more risk. Lehman's assets to real tangible common equity reached 44 to 1. If asset value were to fall only 1% it would reduce real tangible common equity by half, which would increase leverage to 80 to 1, at which point confidence in the firm would be irretrievably lost.

Lehman's Board of Directors was inexperienced at overseeing a diversified investment bank holding company. Only one outside member had any background in the financial sector. The Board failed to put any brakes on an expanding portfolio of commercial real estate and increasingly toxic securities. Between 2000 and 2007 the so-called risk committee met only twice a year yet the Board awarded total remuneration of close to $500 million to Chairman Fuld. Four days before its collapse and following an announcement that the firm lost almost $4 billion in the third quarter, Fuld told the media that "the Board's been wonderfully supportive."

Lehman had been looking at taking on a strategic partner to buy 10% to 15% for some time. The firm approached AIG in 2006 and Sovereign Funds and other institutional investors in the Middle and Far East in 2007. Secretary of the Treasury, Hank Paulson, was encouraging the firm to find a buyer. Fuld, however, thought the company should be selling at a premium and not a discount. Early in 2008 the stock was getting hammered despite reasonable results. Management took the opportunity to dole out shares to staff in the belief the price would soon rebound and yield large payouts.

THE DOWNFALL

In the beginning of 2008 Chief Financial Officer, Erin Callan, was asked at a regular investor update conference call why Lehman Brothers was not in need of a capital restoration program. Ms. Callan responded with a number of points:

- Lehman did not need more money
- the company had not yet posted a loss during the credit crisis
- the firm had industry veterans in the executive suite who have perfected the science of risk management
- the bank's real estate investments were top notch
- we know when we need capital and we do not, and right now there is no way
While she later tempered these remarks it served to focus analysts’ attention on Lehman.

As the credit crisis grew, investors began to get nervous about Lehman and the stock fell 45% in two days in March after the Federal Reserve's assisted bailout of Bear Stearns. With Bear out of the picture Lehman was the smallest investment bank on Wall Street.

At the end of the first quarter the bank announced a small profit of just under $500 million coupled with write-offs of $1.8 billion. The firm sold $4 billion in capital.

As the property market cratered Lehman reacted by selling assets but not as aggressively as it needed. The selling of assets crystallized losses. In June Lehman had to announce 2nd quarter results earlier than usual. It announced an unexpected loss of $2.8 billion. The President, Joe Gregory, was replaced. Mr. Gregory had been a close ally of Chairman Fuld and his chief supporter. The CFO, Erin Callan, was demoted. There was severe discord within the firm; many of the senior managers were troubled about the lack of an aggressive plan to address the company's problems - especially with respect to dealing with the overvalued commercial real estate. Very experienced staff began to leave.

Lehman raised another $6 billion in capital and explored selling parts of the business. Neither the management changes nor the promises of a turnaround arrested the company's downward spiral and the stock continued to fall.

In early August Lehman thought it had a deal to sell a 25% stake in the company to the Korean Development Bank at $22 a share. But Fuld was pushing the Korean Bank to also take some of its underperforming assets. The Koreans balked and were becoming spooked by the ballooning toxic property losses. The stock continued to slide to under $10 a share and the expected deal cratered.

On September 7th the U.S. government seizes control of Freddie Mac and Fannie Mae, the two big mortgage companies, because of large losses.

On September 10th Lehman announces losses of $3.9 billion and the market expects a concrete plan to deal with the downward spiraling property values and resuscitate the company. They are disappointed as Fuld's plan is to spin off $60 billion of toxic rubbish into a bad bank leaving $600 billion in a good bank with solid assets. The Head of Equity trading in Lehman reflects the mood of the market as he says "if this is all we have as a plan we are toast."

The next day, JP Morgan asks for additional $5 billion in collateral to secure Lehman's trading and settlement account. Credit rating agencies warn Lehman if it cannot raise additional funds over the weekend it would face a downgrade. Such an action would be a death blow to the company. Fuld believes that Lehman's access to the Federal Reserve's extended facility program
to provide liquidity to investment banks which was set up after Bear Stearn’s failure means the firm can’t fail.

On Friday, September 12th there is massive withdrawal by clients, and other firms wanted similar trading guarantees as JP Morgan had received. Lehman was running out of cash. On Friday evening the Federal Reserve Bank of New York asks the CEOs of the four other investment banks to come to a meeting at 6 o’clock. Present in the room is Chairman of the Federal Reserve Board Ben Bernanke, Federal Reserve Bank of New York President Tim Geithner, Secretary of the Treasury Henry Paulson and SEC Chairman Christopher Cox. Secretary Paulson tells the assembled group that "there will be no public bailout." They are asked to think about the consequences that a Lehman failure might have on the market and their respective firms and meet back at the New York Fed at 8:00AM on Saturday.

Late Friday evening the Head of Investment management for Lehman Brothers called his cousin, President George W. Bush. The White House operator told him she was "deeply sorry but the President was not able to take his call." Lehman Brothers was out of options and it was now clear that no government support was likely.

Bank of America had been looking over the books of Lehman Brothers in anticipation of a possible acquisition. By early Friday the Bank of America due diligence team concluded that Lehman’s real estate portfolio was worse than it expected and that liabilities considerably exceeded assets. No deal could be done without some sort of government assistance. They left New York to return home to Charlotte, North Carolina.

Meanwhile, John Thain, CEO of Merrill Lynch, another severely distressed investment bank, realizes that if Lehman Brothers fails his company will likely be next. He calls the CEO of Bank of America, Kenneth Lewis, to see if there is interest. The due diligence team is told to turn around and head back to New York. Kenneth Lewis joins them on the flight North. At the Lewis home in Charlotte, after repeated calls from Fuld, his wife Donna Lewis finally tells Fuld that if Mr. Lewis wanted to talk with him he would have called back by now. If Bank of America is to make an acquisition this weekend it will be Merrill Lynch and not Lehman Brothers.

On Saturday, September 13th, the investment bank participants reassemble at the New York Fed and are divided into three groups to address a number of public policy and market concerns. They are asked to advise on:

a) the potential fall out of a Lehman failure  
b) the value of Lehman's toxic real estate investments  
c) the possibility of an industry-led bailout for Lehman's.
No one on Wall Street doubted that failing to do a deal to save Lehman would be catastrophic. Investors would continue to suck out money from whichever bank looked to be the next in danger of failing. The Government needed to be part of the solution but yet Treasury Secretary Paulson was adamant that market discipline needed to be restored. He personally believed that the market had had a sufficiently long time to prepare for Lehman’s collapse. He also believed that the U.S. banking system was safe and sound. He was wrong on both counts.

The only possible deal on the table was one that involved Barclay's Bank buying Lehman sans the soured real estate assets. A bank syndicate might be arranged to support a separate company containing the bad real estate assets. Two problems were evident. One, the bank syndicate would want some participation from the government to absorb part or all of the losses. New York Fed President Geithner reiterated that the Government’s position was not a negotiating ploy and any official assistance was out of the question. The banking sector was not in a position to absorb losses of this magnitude or make a long term funding commitment to hold the spoiled assets until the market turned. Secondly, Barclays would need a waiver from the Financial Services Authority in the U.K. to permit the purchase without prior shareholder approval which the FSA was not likely to grant. By Sunday evening time was quickly running out.

At 8:00PM Sunday night SEC Chairman Christopher Cox, at the urging of Secretary Paulson, placed a call to the assembled members of Lehman Brothers Board of Directors. He told them that they had a serious and grave matter before them. One of the Directors asked if the SEC was directing Lehman to file for bankruptcy. After a few moments of dead air Mr. Cox repeated his comment that the Board had a serious matter to attend to. With all options exhausted the Board agreed to file for bankruptcy.

Federal Reserve President Tim Geithner informed the CEOs of the major commercial and investment banks "it is time to spray foam on the runway. Lehman Brothers has failed."
APPENDIX

THE REGULATORS

The United States has a quilt work of supervisors combining both State and Federal Agencies. Additionally, there was a bias toward self-regulation especially in the securities area.

Investment banks are subject to supervision by the Securities and Exchange Commission (SEC), the State of New York, and Self-Regulatory Organizations. There is no clear evidence of coordinated supervision and with the number of supervisors active in overseeing the activities of Bear Stearns it was surprising there were no alarm bells raised on a number of critical issues – most importantly – capital adequacy.

The SEC lacks the authority to force large investment banks, including Bear Stearns, to report their capital, maintain liquidity, or submit to leverage requirements. Since they lack reporting requirements it is highly conjectural whether they could enforce any prudential rules.

Since all of the large investment banks, including Bear Stearns, had major operations in EC countries they needed, under EC rules, to have a consolidated supervisor. That was absent in the United States since the SEC lacked specific authority to act as the regulator of investment banks. The State of New York had authority to regulate and supervise activities of the chartered bank but had limited or no authority over non-bank subsidiaries, the holding company or subsidiaries of the holding company. In order to continue operations in the EC the investment banks submitted to a voluntary program called the Consolidated Supervised Entities (CSE) program which was inaugurated to fill the regulatory gap as to investment bank holding companies created in the wake of the passage of the Gramm-Leach-Bliley Act.

Since the collapse of Bear Stearns and the bankruptcy and liquidation of Lehman Brothers, the other major investment banks have converted to Bank Holding Companies supervised by the Federal Reserve. The CSE program is no longer in effect.