The Fall of Lehman Brothers: The Recession Way

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"The collapse of Lehman Brothers has sent a major jolt through global financial markets as it is, by far, the biggest victim of the credit crisis that started in August 2007 and had been considered too big to fail."[1]

- Howard Archer, Economist, Global Insight, 2008

INTRODUCTION

On September 15, 2008, the whole world was shocked after hearing the announcement of Lehman Brothers Holdings Inc. to file for bankruptcy, one of the largest bankruptcies ever known to the US economy. The recession was on its peak and one of the world's largest investment banker (Lehman Brothers) decided to opt for bankruptcy in order to protect its assets and maximize values. Lehman Brothers reported the loss of $ 3.9 billion along with fresh write downs on mortgage assets in its third fiscal quarter of year 2008[2]. Lehman Brothers had assets of $639 billion at the end of May 2008. When it filed for bankruptcy protection, it also reported to have a debt of more than $ 613 billion. "This bankruptcy filing represented the end of a 158 year-old company that survived world wars, the Asian financial crisis and the collapse of hedge fund Long-Term Capital Management, but not the global credit crunch"[3]. This bankruptcy also represented the painful end of the four decade old career of the CEO of Lehman Brothers Holding Inc. -Richard Fuld, who had been leading this investment bank successfully since a long period of time.

Financial institutions world wide have confirmed the write down and credit loss of more than $ 500 billion as the US sub prime crisis reached the global market. The collapse of major investment banks (Lehman Brothers, Merrill Lynch and Bear Stearns) raised the question on the sustainability of the business models adopted by these investment giants. Unlike commercial banks, these investment banks accrued enormous liabilities in the form of market borrowings comparative to the deposits. Accordingly, these banks added more risk to their portfolio that resulted in their tragic end. The investment banks like Morgan Stanley and Goldman Sachs took a more cautious approach in lending to real estate, and finally, they converted themselves into commercial banks in order to survive at the time of the economic turmoil.

US SUB PRIME CRISIS & ECONOMIC SLOW DOWN

"The sub prime mortgage crisis is an ongoing financial crisis triggered by a dramatic rise in mortgage delinquencies and foreclosures in the United States, with major adverse consequences for banks and financial markets around the globe"[4]. This crisis started by the end of 20th century, and it became obvious in the year 2007 and brought out the pervasive weaknesses of the financial industry regulation in the global financial system. In the recent years, countless sub prime mortgages (home loans) were granted to the American borrowers whose credit record was not sufficient to get mortgage in the conventional financial system. Although these sub prime loans were highly risky as they were given to people with low credit worthiness; number of lenders got into this business to try their fate and make quick money.

Since these borrowers were not able to comply with the stringent requirement of the commercial banks, no bank would offer loan to these borrowers. At the same time, financial institutions having a good credit rating and willing to take a risk entered in the game in between the commercial bank and borrowers. These institutions entered as they realized the willingness of customers to pay more interest as they were finding it very difficult to secure a loan directly from the bank. Sub prime loans were given to individuals via intermediaries without

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[1]http://www.news.com.au/story/0,,24348416-2,00.html
[2]Priya, C Krishna & Deepika, B Venkata (2008), "The Fall of Lehman Brothers", *Professional Banker*, November issue, pp. 27-30.
[3]"Lehman Brothers Holdings Files For Bankruptcy", www.recession.org, Monday, September 15th 2008.
[4]http://en.wikipedia.org/wiki/Subprime_crisis

evaluating them on strict parameters that should normally be exercised by a commercial bank. As these intermediaries (financial institutions) got good credit rating, banks were keen on giving loans to them at certain rate of interest. These intermediaries used to divide the loan into a lot of small amounts and offered it as home loans on higher rate of interest to those borrowers who could not get a loan because of bad credit record. This higher rate of interest is considered as the sub-prime rate and this home loan market is referred to as the sub-prime home loan market. At the same time, prime home loan market refers to borrowers having good credit ratings and to whom the banks lend directly[5].

These financial institutions who took a loan from the commercial bank and gave it to the borrowers as home loan, without planning for the repayment of the principal amount and interest to the bank went ahead for the Securitization of the loan. They converted these home loans into financial securities, which assured to pay certain rate of interest and later, these securities were sold to big institutional investors. Here, investment bankers came into the scene, and they started financing and selling these complicated securities that were supported by high risk debt. Whenever the sub prime borrowers used to pay EMI (equated monthly installments), it was passed on to these investment bankers and institutional investors. And accordingly, the commercial bank used the money to get the principal amount along with interest. Most of the sub prime loans were given on floating interest rate and these rates used to change accordingly. With US interest rates rising, EMI also used to rise simultaneously. In the financial year 2006-07, the price of home (real estate) started declining; refinancing became more difficult and as adjustable-rate mortgages began to reset at higher rates, mortgage delinquencies soared[6].

Here, sub prime borrowers found it very difficult to pay EMI and started defaulting. As the borrowers could not pay the EMI, payments to the institutional investors who had purchased financial securities stopped and investment bankers involved in the business accrued heavy loss.

WHAT WENT WRONG WITH LEHMAN BROTHERS?

Lehman Brothers came into the picture in 1844, when Henry Lehman, the 23 year old son of a cattle merchant emigrated from Germany to United States and opened a dry goods store in Montgomery, Alabama. Three years down the line, his brother Emanuel Lehman also joined the business and the firm became "H. Lehman and Bro". In the year 1850, Mayer Lehman, the youngest brother also came in the scene and the firm changed its name again, and finally it became "Lehman Brothers". In 1850, 'cotton' was one of the most important crops in Southern United States.After realizing the opportunity, Lehman Brothers entered in the trading business of cotton. In a small period of time, the firm became a leading one in this industry. In 1855, Henry died because of yellow fever, the remaining brothers continued to focus on their commodities-trading/brokerage operations. Lehman Brothers started with this background and became one of the top investment banks of the globe.

It was seen that for Investment Bankers including Lehman Brothers, the major portion of the revenue was coming from trading business and return earned from investment banking. Between 2002 to 2006, investment banking contributed less than 20% of average total revenue for the top four largest securities' firms of the US. Trading accounted for as much as 70% in some quarters before it declined to almost 50% in the second quarter of the year 2008. Trading through hedge funds, which are demand deposit, was a risky game as the downturn in the market and pressing withdrawal from these hedge funds made Lehman Brothers cash-strapped.

Lehman Brothers borrowed heavily to fund their mortgage investments, which finally proved fatal for them. The high leverage in comparison to its capital was also one of the important causes of Lehman Brother's failure. Between 2004 and 2007, Lehman swelled its balance sheet by almost $300 billion through purchase of securities often backed by residential and commercial real estate loans.

It was surprising to note that Lehman Brothers made a deal in October 2007 when the real estate market was about to collapse. The firm paid a massive amount of $22.2 billion to do a leveraged buyout of a big apartment developer, Archstone. At the same time, Lehman Brothers was also blamed for maintaining no transparency about mortgage securities in its books.

Lehman Brothers was very famous for offering exorbitant compensation to its employees in order to attract and retain management graduates from top business schools of the world. The CEO of the firm, Richard Fuld had

[5]"What is subprime crisis? How it caused financial mayhem?" September 25, 2008.
Source: http://specials.rediff.com/money/2008/sep/25slid1.htm

[6]http://en.wikipedia.org/wiki/Subprime_mortgage_crisis

cashed out almost $500 million worth of stocks in his tenure. The Christmas bonus in March 2008 was $22 million, ironically, when the company was reporting a net loss of $2.8 billion. In the fiscal 2006 and 2007, Fuld earned a total of more than $80 million, an astounding sum for a company of Lehman's size. Even general counsel of Lehman had made $12 million in each of those years[7].

Unlike other commercial banks viz. JP Morgan & Bank of America, Lehman Brothers did not maintain stable cash reserves to finance sub prime supported securities. Instead, they used to borrow short term loans, which had to be refinanced. The business of borrowing short term loans, financing and refinancing sub prime supported securities was running smoothly as long as mortgages and other securities of Lehman Brothers were stable and rising. Former CEO of Morgan Stanley, Anson Beard has said, “If you're betting with other people's money, you are more willing to take a risk than if it's your own.” When real estate value in United States started to fall, Lehman Brothers could not sell securities it owned and incurred heavy losses. At the same time, as Lehman Brothers had no access to a newly-created Federal Reserve window for short-term financing, it could not save its position and it came to an end.

CONCLUSION

Knowing that Lehman Brothers had billions of dollars as bad investments in its books, Treasury Secretary Paulson had suggested Lehman Brothers's CEO, Richard Fuld to insistently look for a buyer as he said that Federal Reserve could not bail out Lehman Brothers, the way they did AIG and Bear Stearns by lending as Lehman Brothers did not have enough good assets to offer as collateral securities. Potential Buyers did not take an interest to buy Lehman Brothers because they could not find government backing for the deal as they found for Bear Stearns[8]. The US Government is severely criticized for their inability to react to the crisis to save the global financial giant. Subsequently, Lehman Brothers decided to file for bankruptcy protection under chapter 11 as they could not find a good buyer. The bankruptcy protection filing under Chapter 11 did not include Lehman Brother's broker-dealer operations and other units, such as asset management firm Neuberger Berman. Those businesses will continue to operate, although Lehman Brothers is expected to liquidate them.

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[7] Ravikant (2008), Anatomy of Lehman Bankruptcy, *Treasury Management*, November issue, pp. 24-28.
[8] Rao, V Maruthi (2009), “(Mis) Management at Lehman Brothers”, *Icfai Reader*, January Issue, pp. 57-60.

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AARs are statistically not significant and therefore, we accept the null hypothesis that AARs tend to be zero. However, CAAR gives better indication of the presence of excess abnormal returns. Of the 61 t-values under both market model with raw returns and market model with log returns, 58 (95.08%) and 59 (96.72%) respectively are statistically significant. This shows the presence of excess CAARs and therefore, we reject the null hypothesis that CAARs tend to be zero. This indicates delayed stock price response that contradicts semi-strong form of efficient market hypothesis.

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