Lehman Brothers

Reading Project: Financial Risk MVE220/MSA400

LEHMAN BROTHERS

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1 Introduction

Before The Financial Crisis in 2007/2008 The Lehman Brothers were one the biggest banks in the United States and like many other banks took way too big risks. One main reason for these big risks were the deregulation of the financial industry that took place in the late 90s and early 2000. The financial crisis was an international crise all over the world and Lehman Brothers' fall could be seen as the beginning of many years of financial uncertainty all over the world. Lehman Brothers rise and fall will be the main topic that will be discussed throughout this paper.

2 Growth & Foundation

Lehman Brothers Holdings Inc. is a former global financial services firm founded by three of the Lehman brothers in 1847, in Montgomery, Alabama. At the beginning of the business, cotton was the main market. Then the firm increased the scope of its business to the emerging market of railroad bonds and to the financial-advisory business. [1] The bank became a member of the New York Stock Exchange in 1887. This time is also when the bank is opening new offices across Europe and Japan, specializing in trading financial operations.

All along the 20th century, the strategy of Lehman brother bank was based on the diversification of their businesses. The firm is indeed going through the great depression by operating on venture capital while the equities market recovered. Thanks to this strategy, the firm got itself out of the crisis stronger than before and was able to continue its growth. After World War II, the firm bought Abraham & Co and merged with Kuhn, Loeb & Co. The company was sold in 1984 to American Express for $360 million and spun off in 1994 as Lehman Brothers Holdings, Inc. [2]

All of this led the bank to become the fourth bank in the United States before the crisis.

3 Pre-crisis

Dick Fuld took over as CEO after they spun off from American Express in 1994 and under his command the revenue would increase over 600% and Lehman Brothers were one of the main banks in the United States. The increasing risks would at first lead to larger winning [4].

3.1 2000-2006

After 1994 when Fuld took over Lehmann brothers adapted more and more different financial services that were a lot more complex due to the deregulation of the financial industry in the late 1990s and early 2000. Especially the repeal of the “Glass-Steagall Act” which prohibited connections between investment banks and commercial banks. Lehmann traded with their own money, so called proprietary trading, and the revenue of that went from 14% of total revenue in 2000 to 21% by 2006. During Richard Fuld's time as CEO the total revenue went from 2.7 billion dollars to 19.2 which is an increase by 600%, this from 1994 to 2006. This would also mean that the equity market recognized this and their market capitalization growed 340% over the same period. These numbers made Lehman Brothers outpace their rivas’ by far [4].

A housing bubble grew and Lehman Brothers, among a few other banks, started to give out so-called subprime and Alt-A loans. These were loans with higher risks and therefore also tended to be more expensive for the borrower with higher fees and/or interest rates. Which at first looked like it worked when the real estate business made the revenues in the capital markets grow by 56% from 2004 to 2006. and they also reported record profits every year from 2005 to 2007. Which also led to their highest market capitalization in february 2007 of almost 60 billion dollars. But acquiring five mortgage lenders during 2003 to 2004 made them later on a leader in the game of mortgage loans’ [3] [4].

3.2 New business strategy 2006 →

In 2006 Lehman Brothers also adopted a new business strategy that involved keeping assets like it was their own investments instead of moving to third parties and lowering the risk. This would increase the profits and thereby their markets share by retaining all the returns but also all the risks. They now didn’t have the security demands from the third parties that otherwise would be necessary and therefore could give out even more loans. They targeted loans to firms that were either highly leveraged or speculation-firms which could offer higher returns. But as always higher returns ment higher risk in the form of increased liquidity and credit risk. Which thereby puts a lot of capital into risk and costs a lot of money when the borrower defaults [3][4].

These loans were given out continuously and made it hard for Lehman Brothers to establish some kind of cash capital and also to hedge these enormous risks. And even though the housing prices started to decline in the mid of 2006 and some parties were leaving the subprime mortgage market the Lehman Brothers were still out there giving out high-risk loans[4].

4 Financial crisis

By 2007, unrest regarding the housing market was rising as an increased number of subprime mortgages were defaulting [3]. Meanwhile, Lehman Brothers, like other large Investment Banks, operated a high-risk, high-leverage business and would hold a large position of 111 billion USD in commercial and residential real estate-related assets and securities and they would also report a leverage ratio of 30.7x in November 2007. The declining housing market would mean that the Investment Banks were demanded to reduce their leverage which could be done either by selling assets or increasing equity, with the former being Lehman Brothers main strategy. However, due to the market conditions, Lehman Brothers would find it challenging to sell off these assets at an acceptable price, and they would also be unwilling to sell the assets at lower prices, as it would potentially affect the value of other similar assets, leading to even bigger losses. At this time, Lehman would come to increase the use of Repo 105s, a sale and repurchase agreement, as these agreements could be classified as sales instead of loans. The agreement essentially meant that assets posted as collateral could temporarily be moved off the borrowers books. This was done in order to mask their financials and make them seem more financially healthy [4].

In an attempt to buy time Lehman would increasingly come to rely on short-term debt to finance the bank's long-term assets, while looking for a suitable long-term solution. Concerns regarding Lehman's financials would, in early 2008, however lead the bank finding it increasingly difficult to secure funding as other institutions would either deny their requests or demand increasing amounts of collateral [4].

Following Bear Stearns almost collapsing in March 2008, the market had concerns regarding Lehman being next in line which would lead to their stock falling by 48% [3]. Lehman would come to report a loss of 2.8 billion USD in the second quarter, the first loss since the bank went public, as well as an expected loss of 3.93 billion USD for the third quarter, with both losses being largely due to write-offs. In an attempt to alleviate the market's concerns the bank would announce the raising of 6 billion USD in equity in June as well as plans to separate 50 billion USD of bad assets from the properly functioning parts of the firm and move the assets into another corporation. These attempts would however prove fruitless as rating agencies would threaten Lehman with lower debt ratings if a solution with another strong partner wasn't going to materialize soon. In the end Lehman Brothers would fail to find a suitable partner rendering the bank unable to fund operations on September 15^{th}, leading to the bank having to file for Chapter 11 bankruptcy protection [4].

5 Post-crisis situation

Lehman brother's bankruptcy is seen in popular culture as the main cause of the financial crisis. The experts nevertheless agree that this was more a symptom of the crisis than a cause. Some smaller banks were indeed in huge difficulties before the Lehman brother's bankruptcy. Actually, some banks even bankrupted before the Lehman brothers, like New Century financial for example. The Lehman Brothers bankruptcy is the tipping point that triggered the huge scale crisis.

To speak about the post-crisis situation of the bank, it's relevant to mention that even ten years after the bankruptcy, Lehman Brothers was still existing, but not operating as before. Dozens of employees and lawyers are still working on contract resolution and are trying to sell the last asset [5].One also must notice that Barclays (the biggest British bank) bought the American branch for less than 2 billion dollars, while Nomura (a Japanese bank) bought European and Asian branches. Additionally, the former CEO Dick Fuld admitted just a few mistakes and mainly blamed the government for Lehman bankruptcy. He declared in 2015 regarding the crisis management : "Whatever it is, enjoy the ride. No regrets." [6]

Most people consider Lehman Brothers to be responsible for the financial crisis. These accusations are highlighted in popular culture through movies like Despicable Me. The bank mentioned is indeed named "Bank of Evil" and below in small letters "Formerly Lehman Brothers". Many other movies or documentaries are using Lehman Brothers to depict the subprime crisis, showing that this bank is the main symbol of this world financial crisis.

6 Personal Conclusions

Lehman Brothers bankruptcy is according to us the biggest “brain association” with the financial crisis. The integration in the pop culture of this bank highlights the trauma that this bankruptcy embodies not just for the financial environment, but for the whole society. Moreover, the controversy about “Should the US government have saved Lehman Brothers?” is still questionable and is proof that the wound has not healed yet.

In the months leading up to the bankruptcy Lehman, as stated earlier, relied heavily on Repo 105 agreements. One could call into question whether the Repo 105 agreement is ethically sound and if it should even be legal at all, as the use of the agreement was essentially intended as a deception to make Lehman seem better than they were.

Lehman Brothers was no doubt part of the problem that led to the big financial crisis and as concluded the main association for a lot of people. Since there were more banks that did pretty much the same thing and like in the case of Bear Stearns were saved by the government. The Lehman Brothers may be the face of the financial crisis but not the whole reason. Picturing Lehman Brothers as the big evil player is too harsh but more the player that took the biggest hit.

7 Reading guides

Our group used [5] mainly for the facts that described Lehman Brother's role during and after the crisis but in the second part of the article, the journalist is assessing the winners and the losers of the crisis. In the third part, he is thinking about the future, and answers questions like “Is such a crisis still possible?”, “Did banks really change their functioning?”, or even “Is our society at the dawn of a new major crisis?”. This article is indeed great to think about the current situation by looking at a classic case such as the link between Lehman Brother bankruptcy and the financial crisis. Furthermore, we recommend “The Lehman Brothers Bankruptcy A: Overview”, as the article presents a clear explanation of the events leading up to the demise of Lehman Brothers.

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