

What Caused the Failure of Lehman Brothers? Could it have been Prevented? How? Recommendations for Going Forward

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Abstract

This paper discusses the reasons behind the Lehman Brother's failure. It analyses whether it could be prevented and what measures were necessary. We open the discussion with the factors that led to this event followed by company history. Some of the leading causes were the bazaar for Credit Default Swaps, falsification of financial statement, and unethical behavior of top executives. In the falsification of financial statements, Repo 105 procedure played a major role in creating healthier financial statements for Lehman. Several recommended that the falsification by the top managers dishonored the Sarbanes-Oxley Act. The paper concludes with the supreme size and universal scale of the crisis, and the incomparable reaction of the government, to stabilize the system, calls for a cautious assessment of the financial system.

Keywords: Lehman brother's failure; Credit ratings; Financial statement; Financial system

Introduction

Between 2003-2004, Lehman obtained five mortgage lenders, together with the BNC Mortgage and Aurora Loan Services, which focused in ALT- A loans (without complete documentation to borrowers) during the housing boom in the USA [1]. Lehman's acquirement appeared perceptible; income from Lehman's real estate businesses allowed income in the capital markets unit to flow to 56% between 2004-2006, a quicker rate of growth [2]. The firm securitized \$146 billion of mortgages in 2006, a 10% increase from 2005, and accounted record profits until 2007 [3]. In 2007, the firm announced the net income of \$4.2 billion on \$19.3 billion revenue [3].

Within 72 hours, Lehman Brothers filed for Chapter 11 insolvency procedures [4]. The 15th September 2008 will be remembered as the largest bankruptcy in the US history, outstanding USD\$613 billion to creditors [4]. The Dow Jones Industrial Average (DJIA) dropped an approximate 500 points instantly [4]. On the 18th September 2008, the collapse provided the impulse for an enormous money market move, where in a span of two hours, US\$550 billion changed hands witnessing an immediate response and injection from the U.S. Treasury of US\$105 billion [4]. The electronic money market operations closed down soon when no response had occurred concerning the above [4].

The Lehman failure leans-to countless interrelated and mutual causes that added to the failure of major financial institutions, including [2]:

- Irresponsible lending practices, viewed as a risk cutback mechanism.
- Excessive dependence on credit ratings by investors.
- An extensive view of markets, assuming they could auto correct themselves and an inadequate appreciation of the risks of deregulation, led to weaker principles and regulatory breach.
- The explosion of complex financial products, together with derivatives, with lack of liquidity and other risk characteristics that were not transparent or understood.
- Vicious incentives and asymmetric return arrangements encouraged unwarranted risk-taking.

- Deficient management of risk and oversight of companies involved in marketing and purchasing complex financial products.
- Lack of monitoring in financial regulatory framework and lessening the risks across has synchronized entities and markets.
- The lack of an adequate legitimate framework for the lapse of large investment bank holding companies on a consolidated basis [2].

History

Lehman Brothers Holdings, with 209 registered subsidiaries in 21 countries, filed for bankruptcy after they failed to sell the company [5,6]. In reality, Lehman's was a 14-year-old firm with an aged name (158 years) [4]. Creditors filed about \$1.2 trillion of claims against the Lehman estate (LBHI, "The State of the Estate," September 22, 2010) (Appendix), which was party to additional 900,000 derivatives contracts at the time of bankruptcy [6]. The Chief Executive Officer, Richard Fuld, reported the major loss in its history as diminished real estate possessions led to writedowns of \$5.6 billion in the third quarter [5]. Below listed are the events that occurred in the Company's timeline:

Henry Lehman, from Germany, and Emanuel and Mayer (brothers) established a cotton buy and sell business in Montgomery, Alabama, called Lehman Brothers in 1850 [5].

In 1889, the cotton trading business expanded into investment banking, where Lehman launched its first stock offering [5].

In 1929, after the market crash, Lehman offered financing to

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companies using creative ways during the Great Depression. If, the financial advisor under prices the loans extended to the acquirer in order to win worthwhile merger advisory business, then the blend of lending and advisory services may reduce its value, before enhancing it [7].

In 1977, Lehman merged with opponent Kuhn, Loeb & Co. [5]. In 1984, American Express Co. bought Lehman Brothers. In 1993, Fuld became the CEO.

In 1994, American Express separates the business with Lehman offering little Capital and burdened them with losses, admitting that it was not good enough for the credit card organization.

In 1998, Lehman shares fell 63 percent within three months due to default of Russian debt [5]. The shares improved after the bank got rid of 20 percent of assets and profit growth revived again [5].

In 2002, the firm bought 745 Seventh Avenue for constructing the Midtown building as its headquarters [5]. In 2003, Lehman bought Neuberger Berman for \$3.2 billion to enhance its wealth management industry [5].

In 2007, the firm beats opponent Bear Stearns Co as the biggest underwriter of mortgage-backed securities [5]. After some time, BNC Mortgage, LLC, the subprime-lending unit was shut, eradicating 1,200 jobs [5].

On March 2008, Lehman shares fell to 48 percent on the concern that it would collapse after Bear Stearns, was forced to sell for 7 percent of its market value the previous day [5]. Lehman stock recovered from its loss when the first-quarter profit exceeded analysts' estimates [5].

On May 2008, David Einhorn, hedge fund manager, raised a query in Lehman's earnings report, since the bank announced less problems in the first quarter [5].

On June 2008, the firm announced its first quarterly loss after going public and sold \$6 billion of stock to Bolster Capital [5]. Joseph Gregory, president of the firm stepped down [5]. Erin Callan, the public face of Lehman as chief financial officer was removed from her position in December [5].

On August 2008, Lehman shares dropped 13 percent on reports of third-quarter writedowns being worse than estimated, and that the firm pleaded buyers for its investment-management division [5].

On September 2008, Lehman shares fell 45 percent when their talk about capital infusion from Korea Development Bank ended [5]. Lehman reported a \$3.9 billion third-quarter loss, on \$5.6 billion of writedowns [5]. It announced plans to sell a bulk stake in its asset-management unit and spin off commercial real-estate holdings [5]. Lehman's shares sank 42 percent after Moody's Investors Service said the firm must find a strong financial partner or it will downgrade the company's credit rating. Bankers from other firms reviewed Lehman's books for possible bids. Government agencies urge Wall Street chiefs to find a solution. Bank of America Corp. and Barclays Plc emerged as bidders [5]. Without a deal, the firm could face liquidation. Barclays pulled its bid after failing to secure guarantees against losses; Bank of America withdraws hours later. Firms met to net trades, and cancel those that offset each other, as Lehman liquidation or bankruptcy drew near. Lehman petitioned for Chapter 11 bankruptcy, listing \$639 billion of assets in the largest filing in U.S. history.

Discussion of Facts and Issues

Since the confused times of the Great Depression, the banking

and finance industry in the USA functioned under a calm period, even during the Second World War; the 1973 Oil Crisis; the 1982 Mexico Crisis; and the 1997 Asian Financial Crisis [4]. Such stillness was due to Glass-Steagall Act (1933) legislation, whose purpose was to set apart the banking activities of both commercial and investment banking.

It is a belief that financial innovation was the root cause of the evil. The 1990s period saw latest types of securitization that made it possible to pack together large portfolios of loans and sell small tranches of them [8]. However, two problems turned this valuable instrument into a "financial weapon of mass destruction": vague incentives and a lack of lucidity [8].

The Gramm-Leach Biley Act (1999) permitted commercial banks to productively operate more within investment banking. The strategies like savvy business people with an eat what you kill frame of mind, greedy in their mission for huge deals, that were not easily digested into the Lehman culture, but was a significant part of the franchise expansion. The Board required Dick to take more risk and grasp the volatile market opportunities that appeared to be over the horizon.

During the 2000s, financial firms approved large amounts of loans, particularly in the subprime division of the mortgage market, and were "warehoused". These loans were securitized and sold to other investors, which destroyed incentives for cautious behavior. The originators of the loan wanted to shift the risk further down the line and did not care in evaluating the creditworthiness of the borrower [8]. The related risks were spread throughout the entire financial system due to lack of transparency.

The debt to equity ratio provides an indication as to how the company utilizes debt in financing its operations, further providing insight on how the company can meet current and future financial obligations. In Lehman's situation, it was defined by net assets divided by equity. The net assets eradicated certain types of assets from total assets, with intangibles and assets seized as collateral. This reduced the debt to equity ratio and boosted the company's superficial health.

At the time of Lehman's bankruptcy, between 900,000 to 1,000,000 derivative contracts across 8,000 different counter parties beyond belief, held the Lehman name. Whilst all contracts were governed by the 1992 Master Agreement and legislated by the International Swaps and Derivatives Association (ISDA), by the start of January 2009, counter parties to the Lehman transactions elected to end approximately 900,000 of these derivative contracts. However, derivatives were not responsible for the fall of the Lehman Corporation.

Lehman introduced Repo 105 program in approximately 2001 [9]. Lehman carried out its Repo 105 program under the guidance of the Linklaters law firm in London, Lehman's European broker-dealer in London, under English law [9]. In the United States, engaging in a Repo 105 transaction, meant transferring their securities inventory to LBIE for them to conduct the transaction on behalf of Lehman entities [9].

The Lehman Brothers organization was extremely levered, with roughly 3-4% of assets from stockholder's equity, while the leftover assets were supported by debt [10]. Thus, the main stakeholders in Lehman were investors in debt instruments. The CEO of Lehman Brothers, Richard S. Fuld, Jr., owned 2.41% of outstanding common stock, more than 50% of the outstanding common stock held by officers and directors in 2008 [10].

In 2007, housing prices in the United States weakened and U.S. subprime borrowers began to default their loans [8]. Trust vanished from the financial markets, since no one was aware of the degree of

banks' exposure to securitized mortgage loans [8]. This made it difficult for banks to assess their exposure, and began to accumulate liquidity, due to which the money market liquidity was nowhere to be found [8]. Banks could not tap into the interbank market to secure their funding, due to which, the prices of financial assets fell, suggesting banks to sell their assets immediately to limit its losses [8]. Rushing for the exit sent the markets into a downward twist, reducing the thin capital cushions of banks [8].

Lehman engaged in off-balance sheet procedures called, "Repo 105" and "Repo 108" transactions, to get rid of securities inventory from its balance sheet, for 7 to 10 days, to create a deceptive picture of the firm's financial condition in 2007- 2008 [9]. Lehman on a regular basis increased its application of Repo 105 dealings prior to reporting periods to reduce its net leverage, and did not disclose the cash borrowing [9]. Lehman used the cash to compensate other charges, thus dropping both the total charges and the assets written on its balance sheet and reducing its debt to equity ratio [9].

As soon as the next quarter began, Lehman borrowed the mandated resources to pay back the cash borrowing plus interest, buy back the securities, and re-establish the assets to its balance sheet [9]. Lehman never revealed its application of Repo 105 dealings, its accounting conduct, the rise of Repo 105 usage in late 2007-2008, or the material impact it had on the firm's net debt to equity ratio in fear [9]. Lehman positively altered its financial accounts by treating Repo dealings as financing for financial reporting purposes [9].

The U.S. government was accused of practicing socialism for the rich, when the investment bank Bear Stearns was rescued in 2008 [8]. Against this backdrop, the government took a harder stance toward Lehman Brothers [8]. As soon as Lehman filed for insolvency, chaos was in power [8].

According to the proxy statement for the 2008 annual meeting, the non-management directors, with the exception of one director who received no compensation, were paid an average, in excess of \$365,000 (\$420,000) in director fees [10]. The nine directors that received compensation earned a minimum of \$325,000. In addition to the compensation and distributions/returns, eight directors had brokerage or investment accounts with the firm, six directors had invested in investment partnerships, and served on four boards that provided revenue to Lehman Brothers [10]. Thus, while NYSE standards and internal Lehman Brothers standards classified the non-management directors as independent, only one of the ten directors had no financial ties to Lehman Brothers [10].

Analysis of facts and issues

A ferocious cycle resulted where risk was compensated. The accounts published in 2009 produced a culture of boldness and risk, which was excessively rewarded when the firm and its executives generated profits. This promoted hubris that allowed certain managers to believe that it was different and normal rules did not apply to them. Conversely, for Lehman, competing with commercial banks would be a gigantic task by utilizing high amounts of leverage.

Together, Lehman and E&Y supposedly approved the borrowing under agreements to later repurchase the notes as a sale of an asset instead of short-term borrowing arrangement [11]. The attorney general complained that E&Y "substantially assisted Lehman to engage in a massive accounting fraud, involving the surreptitious removal of \$10 billions of securities from its balance sheet", through Repo 105 transactions [11]. The firm speedily amplified its use of Repo 105 as

the financial crisis grew and Lehman was facing demands to reduce its leverage [11].

While not referenced or incorporated into Lehman's internal Repo 105 Accounting Policy, senior management of Lehman set limits on the total amount by which the firm could reduce its balance sheet on any given day using Repo 105 transactions [9]. The former Lehman employees described Repo 105 dealings as an accounting trick and a sluggish way of managing the balance sheet [9]. The management formed 2 rules loosely known within Lehman as (1) the "80/20" or "continual use" rule and (2) the "120%" rule, prescribing a minimal level of continual application of Repo 105 dealings throughout the quarter and a maximum volume of Repo 105 transactions at quarter-end [9].

None could consistently judge the interconnections in the financial system due lack of transparency [8]. It was unclear what the bankruptcy of Lehman Brothers in New York would mean for its subsidiaries in London and Frankfurt [8]. There was no international regulation on the decree of systemically important banks [8]. The problem of imprecise incentives, no transparency, lack of capital, liquidity buffers, and the lack of mechanisms are few highlights for the systemic failure of important banks [8].

The power within the board of Lehman Brothers was centralized in CEO and Chairman, Fuld, who seized more than 50% of the beneficial ownership owned by directors and officers [10]. The one-year term diminished the impact any director could have on board decisions or the board decision-making processes [10]. Fuld was involved in significant financial decisions and understood the importance of reducing leverage to maintain credit ratings and the effect reporting losses would have on the company's survival. Fuld failed to inform other board members of the impact of Repo 105 transactions on financial statements and firm operations, if single transaction limits were to be removed [10].

The stock options in 2008 were exercisable in installments of 1/3 on the anniversary of the grant dates over the coming three years, with ten-year terms and were not forfeitable [10]. Once allegations of Repo 105 usage were made known, the audit committee acted appropriately as needed. The audit committee was also responsible for oversight of the Finance and Risk Committee (Final NYSE Corporate Governance Rules, 303a 7 (b) (iii) (B)) [10]. The authors considered that many of the shortcomings in board's failure to notice could have been remedied by (1) reducing the power of the CEO (2) increasing board member independence and (3) improving the expertise of board members [10].

Lehman's disintegration was associated with ethics and decision-making process [12]. The International Federation of Accountants 2014 stated, five essential doctrines of professional ethics, known as Integrity, Objectivity, Professional Competence and Due Care, Confidentiality, and Professional Behavior [12]. By manipulating their balance sheet and illegal activities, Lehman Brothers broke integrity and professional behavior. In this instance, consequential ethics can be linked to creative accounting. By highlighting ethics and its role in the decision making process, we can see how led to defective accounting practices [12]. The combination of bad ethics and flawed risk management led Lehman Brothers to a remarkable collapse [12].

Yet, it would be wrong to say that contraction of credit market occurred suddenly. Sufficient warning was given beforehand with warning signs such as the tightening of the global credit market appeared about six months earlier with a gradual, yet distinct slowing. However, any highly debt to equity entity holds a narrow window of opportunity to respond to unfavorable market conditions. For

Lehmans, this retention of high proportion of non-liquid investments within the subprime crisis, the ability to relieve of assets became near impossible without incurring significant losses. If such action was taken, the company would be exposed on grounds of: a) the acknowledgment of such losses would reduce equity, and b) the quality of the remaining assets would be infected by prevailing market sensitivity.

Conclusions

The economic failure of Lehman Brothers was one of the largest and most complex in history, surrounding 4 bodies of valid U.S. laws, and insolvency procedures that consisted in excess of 80 international legal jurisdictions [6]. The payment ratio to third-party creditors was initially estimated to be about 21 percent based on allowable claims of \$362 billion [6]. The actual distributions of payments have exceeded initial estimates, some of which has gone to other Lehman entities of Lehman [6]. Customers of centrally cleared securities were generally made whole, and most customers of Lehman's broker-dealer were able to transfer their accounts to other solvent broker-dealers [6]. On the contrary, many counterparts of Lehman's OTC derivatives suffered substantial losses [6]. The bankruptcy report conclusion was that Fuld acted with gross negligence and breached the duty of care in filing misleading financial statements. The poor planning of the bankruptcy process made it expensive and delays in settling claims [6]. On the contrary, creditor losses were more considerable without the ability of Lehman's brokerage subsidiary in the USA, and afterward, of Barclays, to finance positions through the Federal Reserve's liquidity services [6]. Finally, Lehman's interlinks led to delays as per LBHI's creditors argument in court that, because the holding company guaranteed some of the subsidiaries' debt, they were permitted to recovery of a portion from subsidiary assets [6]. The Chapter 11 procedures are based on the application of case law linking to the Bankruptcy Court's prior analysis of cases [6]. Despite the fact that existing case law provided a useful starting point for Lehman's resolution, the court provided new interpretations of provisions in the Bankruptcy Code [6].

The bankruptcy court had to analyze complex financial securities for the first time. In sum, the size and complexity of Lehman, the originality of its structure, and the rarity with which such firms go bankrupt contributed to a prolonged and costly resolution [6]. Because of the Dodd-Frank Act, regulators can resolve optionally large, complex financial firms under the Authority of Orderly Liquidation, through the extended reach of the FDIC [6]. Details of such a resolution to be implemented are still under process, making it tough to evaluate the extent to which the resolution of large nonbank financial firms will be more efficient going forward [6]. Regulators have to ensure that new financial instruments do not pose systemic risks [8]. Currently, good progress has been made with respect to transparency and securitization [8].

Recommendations

The downfall of Lehman evidently shows the relationship between regulations and action management arrangement [12]. The letdown uncovered the deficit in the regulatory system, thereby calling for the urgent need for severe supervision of specific performance indicators such as a firm's liquidity situation, solvency and success [12].

Policy makers such as the International Financial Reporting Standards (IFRS), Securities and Exchange Commission (SEC), the Basel Accord et al, must commence tough policies to address the Lehman failure to prevent some future episode [12]. The good news is that banks today are much better capitalized than they were five years ago, in line with the new international regulatory principles [8]. Firms

are required to fuse with high-quality corporate governance practice to restore investors' confidence via ethical practices and standards [12]. Basel III requires banks to hold more capital to raise the bank's capacity to absorb losses and makes them more flexible against sudden shocks [8]. In this regard, Basel III hangs on to the concept of risk-weighted assets for sensible risk management [8].

There exists a hesitation whether the zero risk weight for government bonds is sufficient [8]. For the first time ever, an international standard on liquidity has been decided on, that can shield banks to a certain degree from liquidity constrict in the money market [8]. If a too-big-to-fail bank runs into trouble, the government enters to prevent a systemic crisis [8]. We have to ensure that large and interconnected banks can fail without causing a systemic crisis [8]. A new international principle on recovery and resolution of systemically important banks has been developed, which is a major step forward [8]. However, the willingness to let an institution go bankrupt is a political rather than an economic decision [8].

The IT and tech spending by the big banks has fallen since 2007. Big Data and increasingly urbane analytics offer huge opportunities to better understand and serve worldwide markets [13]. These could offer regulators with efficient tools, enabling them to detect potential danger and intervene in time to prevent another crisis [13].

By promising liberty, easing long-term planning, and closing the resource crack between the agency and the entities it controls, self-governing funding will permit the SEC to protect millions of investors, by identifying and addressing all types of risks [2]. Tough actions will be taken to prevent future risky activities under its supervision and new responsibilities assigned to it under any future legislation [2].

The FDIC's report states that if Dodd-Frank was in place; Lehman would not have gone bankrupt, as it would have received help from the government to settle its debt [14]. On the other hand, this report was based on numerous suppositions and only time can tell if regulations are beyond doubt efficient since testing has not been done [14,15].

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